CGN 41: A CASE STUDY OF SHIP PROCUREMENT.

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CGN 41:
A CASE STUDY OF SHIP PROCUREMENT

by

David J. Klinkhamer
and
Derry T. Pence

March 1978

Thesis Advisor: S. M. Dean

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CGN 41:
A Case Study of Ship Procurement

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This thesis presents, in a case study format, the conflict between Newport News Shipbuilding and Drydock Company and the Navy over the execution of the option to build the CGN-41. In the case, the reader is taken from the time of the signing of the original contract in 1971 through the events leading to the negotiated settlement reached by Mr. Gordon Rule.

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I. INTRODUCTION

A. THE NEED

All those within the organization of the Navy are aware of the much publicized magnitudes of the shipbuilding claims and cost overruns. These are said to be the results of poor management on the part of those tasked with ship acquisition. There is also an increased awareness of these problems by those in the Congress and in the Executive. While many have prescribed increased procurement education and experience in acquisition management, this may be an inadequate remedy for the shipbuilding malady. Specifically, present acquisition management training seems to concentrate on the procurement of lesser weapon systems and aircraft. It is the conviction of the authors that, in order to understand and apply management skills effectively to shipbuilding, the training materials must be made relevant to the shipbuilding problem. In other words, in order to find solutions to ship procurement problems through study, an individual must study shipbuilding problems.

B. THE CASE METHOD OF STUDY

An excellent tool used by most leading management schools is the case method. This method consists of presenting the student with a large number of facts describing a management problem. The student is left to define the problem, identify

contributing factors, and propose solutions with implementation plans for the solutions. Often a number of alternatives are developed and ranked based on their expected costs and expected results. Thus, a case study provides the opportunity to apply models and hypotheses to what is hoped are realistic circumstances.

In keeping with the case method, the authors have attempted to describe the current ship procurement problem in a manner that introduces the student to this problem but does not provide the student with an instant focus on the objectives of the authors. Teaching notes, however, are provided to the instructor. Because of this, much of the amplifying information or explanatory comment in the text is missing. Also, questions asked by the student in the early chapters will be discussed in later chapters. The student is expected to use an outline to construct his own perceptions.

Group discussion after individual study greatly increases the benefit of the case. The student is expected to take issue with much of the material in this case and also to find topics which he will want to pursue further on his own.

C. THE CGN-41 CHOICE

The CGN-41 case, while not a claims case, covers those issues in a claims dispute, plus other matters, that are often lost to those concentrating on claims; notably, greater insight may be gained into the aims of those involved in actual government-contractor negotiation. This case involves a nuclear ship, a dispute with the largest of our

shipbuilders, and the involvement of all three branches of our democratic system. Most important, it has evoked strong and clear expression of the values and perceptions of those involved.

The authors hope that this study will result in a better understanding of shipbuilding problems. At the very least, our objective is to foster greater respect for the opinion of those closest to the problem than is evident in such often-heard solutions as "the problem will go away when Rickover dies" or "all that is needed is a little more front end attention."

D. SOURCES

The Naval Center for Acquisition Research has only recently been established at the Naval Postgraduate School in Monterey. Many supportive activities within the Department of Defense have made available their files for the express purpose of developing more relevant training materials. In addition to this rich source, much information was found in the public record of testimony and material provided to Congressional committee hearings over the past ten years. Included in that material was the Court Decision in the case. Much was found in Navy manuals, instructions, and funded studies.

The authors were afforded the opportunity to interview Mr. Gordon Rule, Admiral Manganaro, various project managers, and other Department of Defense officials. During the past two years, the authors have taken advantage of the visits

of these and others to the Naval Postgraduate School to ask off-the-record questions. While this information was invaluable in guiding the authors, the material in the case is taken from the written sources. Although the absence of this off-the-record comment is not important to the use of the case, in order that they may appreciate the concern, dedication, time and energy devoted toward solution of shipbuilding problems by cognizant Navy officials, it is hoped that similar opportunity could be afforded to those who study ship procurement.

E. A SHIP ACQUISITION MANAGEMENT COURSE

While this case might be used in a number of different management courses, it is designed to be used with other cases in a course devoted solely to ship acquisition. In this course, contract types, industrial capabilities, labor law, escalation procedures, profit studies, and other topics might be explored in the context of ship procurement.

CGN-41 CASE

II. THE NAVY LOSES CGN-41 CONTEST

A. CGN-41 DEADLOCK

After a year in the Federal District Court of Eastern Virginia, the Navy, in mid-1976, faced an impass of not being able to reach a settlement with its contractor, Newport News Shipbuilding and Drydock Company (NNSDCO), over the validity of an option to build the nuclear guided missile cruiser, CGN-41. The contractor had stopped work on the ship and the Navy had taken the company to court to obtain an injunction to force NNSDCO to continue work. Under pressure from the DoD, the Navy, represented by the Attorney General's office, agreed to a court order to negotiate a settlement of the option.[1]

Despite the agreement, the positions of both sides (the Navy and NNSDCO) remained unchanged. The Navy felt that it could not negotiate unresolved clauses within the option without renegotiating the validity of the option, and the contractor insisted that this option was invalid. On 13 July 1976, the contractor petitioned the Court, arguing that the Navy had not negotiated as agreed to earlier and requesting that the agreement to work on the CGN-41 be suspended.

On 16 July 1976, Assistant Secretary of the Navy (I&L) Bowers issued a memorandum designating Mr. Gordon W. Rule as the Navy's Chief CGN-41 negotiator. Also, that day Rule reported to DEPSECDEF Clements that he had had his first

meeting with Newport News and that his "...failure to contact the Supervisor of Shipbuilding and Repair Newport News was not accidental."[2]

B. RULE NEGOTIATION AND TURMOIL

Rule opened negotations by contrasting his own style of seeking a nonadversary position with that of the Navy's previous negotiator Rear Admiral Woodfin, whom Rule quoted as saying that the adverse relations were inevitable.

After almost daily negotiations, on 20 August 1976 an oral agreement between Rule and Newport News was reached. The Court found that this understanding covered all outstanding substantive issues concerning the construction of CGN-41, including those charged to Mr. Rule by DEPSECDEF Clements. This agreement was to be labeled Contract Modification P00037.[3]

It is noted that on 19 August 1976, the Office of the CNM issued to Mr. Rule a Certificate of Appointment as Contracting Officer which recited that he had "...unlimited authority to negotiate with the shipyard concerning the CGN-41 contract dispute..."[4] An ASECNAV Bower memorandum stated that Mr. Rule was appointed to negotiate without involvement of the Department of Justice but with the assistance of the Navy's General Counsel.

On the 23rd of August (by telephone) and again on the 24th (in writing), Admiral Rickover informed the Chief of Naval Material that he had heard rumors that a settlement had been reached and that if so, any settlement reached must be

reviewed to see that it was within the original contract or settled under PL 85-804. Admiral Rickover volunteered to provide assistance in any review based on his own knowledge of the events in question.[5]

On 25 August, Newport News issued a press release announcing the settlement. Admiral Rickover stated that this must have caught those senior members of the Navy by surprise as they had been denying the settlement.[6] The press release had been cleared through retired Vice Admiral Eli Reich, a DEPSECDEF Clements consultant, and Mr. Gordon Rule.

The Navy issued its own release that Mr. Rule's settlement was under review.

On 26 August, CNM sent a memorandum to Admiral Rickover telling him to stand clear of the negotiations unless technical areas concerning nuclear propulsion were involved. He also stated that a letter, such as Rickover's broadly distributed letter (24 August memorandum), would cause disrupting perturbations to the negotiating process. In a response to the CNM memorandum, Admiral Rickover said that not informing cognizant Navy officials of the matters involved in the settlement "was analogous to not warning my mother that she was about to fall off a cliff."[7]

In regard to the rumored settlement, Admiral Rickover stated that he had heard the following rumors:

(1) The Navy General Counsel was present but Navy lawyers were not;

(2) Neither the lawyers nor NAVSEA did clear or review in advance the agreement, and

(3) The cost to the Navy was not identified before the agreement was made. Receipt of the draft of the agreement from Newport News would be necessary prior to the Navy's discovery of the cost.

In a letter on 24 August to Attorney General E. Levi, Senator Proxmire related that senior DoD officials were advocating Congressional approval for a quick settlement with Newport News beyond the terms of the contract, and that, in so doing, they were at odds with testimony of expert Navy witnesses who were directly involved with the contracts. He also noted that, although there was a Navy board assigned to handle the Newport News claims, Gordon Rule had been assigned as Chief Negotiator for the CGN-41. The Senator commented that Mr. Rule had publicly laid the responsibility for the Newport News problems directly on the Navy and that a man's views might undermine the Government's ability to enforce contracts. He concluded that there were those DoD officials who would sacrifice the public interest by turning over to shipbuilders sums of money far in excess of the amount agreed to in contracts.

C. RULE'S EXECUTION OF THE AGREEMENT

On 30 August, Adm. Michaelis, CNM, appointed a review panel of three Navy persons and granted them sole and final authority to bind the Navy to a compromise.[8]

At 6:00 P.M. on 7 October 1976, Mr. Rule signed a final draft of the 20 August agreement. On 8 October, he was handed a document dated 7 October 1976 stating..."you do not have

authority to bind the Government contractually on the proposed modification to CGN-41 until the legal and business reviews have been completed..."[9] Gordon Rule subsequently delivered the signed agreement to Newport News. The agreement was subject to two additional conditions:

(1) Deputy Defense Secretary Clements' approval, and

(2) Labor escalation was to be at the lesser rate of 125% of the Bureau of Labor Statistics indices or actual experience.[10]

On 15 October, Mr. Clements forwarded a copy of this writing executed by Mr. Rule to the Attorney General, Mr. Levi, and in his cover letter referred to Mr. Rule's settlement as a "reasonable resolution to this complex matter."[11] Subsequently the Justice Department informed the Court that the Attorney General would disapprove Mr. Rule's compromise settlement.

To sum the various NAVSEA objections to Mr. Rule's settlement, the agreement was a license for the Navy to negotiate new optional delivery dates doing violence to the original contract. The Government had the right to the original delivery date and could not relinquish it without adequate compensation or through extraordinatory relief under PL85-804.

D. THE COURT RULING

The Court ruled that Mr. Rule's settlement was valid and binding. It also found that the Government had not been negotiating in good faith until the appointment of Gordon Rule, but rather had clung to the best and final offer, that

had been its position before entering the Court. The Court stated that in its opinion of the case, that had the Government requested a decision on the option validity after the motion had been filed, they would have had the decision within six to seven months. The Court ruled out the position of insufficient consideration for the settlement on the basis that Newport News agreed to drop its request for claim considerations which they valued at $22 million. The judge found the Government had delayed entering the CGN-38, 39 and 40 changes into the CGN-41 and, therefore, felt the claims justified.[12]

E. POST COURT REACTION

The Navy debated for some time whether or not to pursue an appeal of the case. Some feel that the case allows a contracting officer to receive value for change simply on his evaluation of the Government benefit and that this benefit will require no other supporting evidence.

Specifically, as Admiral Rickover testified to a Congressional Subcommittee, "The Comptroller General has long held that no Government contracting officer is empowered to relinquish the Government's rights without obtaining a compensating benefit or adequate consideration. In return, that is, the quid must equal the quo in any quid pro quo. In many Navy eyes this agreement amounts to extra contractual relief without PL 85-804, which requires the view of Congress."[13]

III. A LOOK BACK

A. THE PROCUREMENT ENVIRONMENT

The agreement reached on 20 August 1976, with NNSDCO by Mr. Gordon Rule, should have settled the CGN-41 issue, but instead, the controversy still raged within the Navy as to whether or not this was a fair settlement from the Navy's standpoint. This is a good point on which to reflect back to the events leading up to the Rule agreement.

Before reviewing the actual events which culminated in Mr. Rule's agreement, we should look at the environment within which the procurement of ships is undertaken. The Navy organization is shown in Exhibits 1 and 2. From these it can be seen how complex the organization is, with its many layers of responsibility. Because of the nature of government and the Navy, the people who head the various organizations in charge of ship procurement change periodically. When the people change, the direction taken in the composition of the fleet changes also.

ADM Rickover in his introductory comments to the House of Representatives Subcommittee of the Appropriations Committee brought out how often these players change. He stated:

> "...I have been responsible for directing the Navy Nuclear Propulsion Program for over 28 years under seven administrations. During this time there have been: 14 Secretaries of Defense--Forrestal, Johnson, Marshall, Lovett, Wilson, McElroy, Gates, McNamara, Clifford, Laird, Richardson,

Schlesinger, Rumsfeld, and Brown, 16 Deputy Secretaries of Defense--Early, Lovett, Foster, Kyes, Anderson, Robertson, Qualies, Gates, Douglas, Gilpatric, Vance, Nitze, Packard, Ruch, Clements, and Duncan; 13 Directors of Defense Research and Engineering, including former positions of Chairman, Research and Development Board, and Assistant Secretary for Research and Engineering--Bush, Compton, Webster, Whitman, Qualies, Furnas, Newburg, Foote, York, Brown, Foster, Curie, and Parker (Acting); 8 Assistants to the Secretary of Defense for Atomic Energy, including former Chairmen of the Military Liaison Committee-Carpenter, Webster, LeBaron, Loper, Johnson, Howard, Walske, and Cotter; 15 Secretaries of the Navy--Sullivan, Matthews, Kimball, Anderson, Thomas, Gates, Franke, Conally, Korth, Nitze, Ignatius, Chafee, Warner, Middendorf and Clayton; 18 Under Secretaries of the Navy--Kenney, Kimball, Whitehair, Thomas, Gates, France, Bantz, Foy, Belieu, Baldwin, Band, Warner, Sanders, Middendorf, Potter, Bowers (Acting), MacDonald, and Woolsey; 11 Chiefs of Naval Operations--Nimitz, Denfeld, Sherman, Fechteler, Carney, Burke, Anderson, McDonald, Moorer, Zumwalt, Holloway; 14 Vice Chiefs of Naval Operations--Radford, Price, McCormick, Duncan, Felt,Russell, Ricketts,Rivers, Clarey, Cousins, Weisner, Holloway, Bagley, and Shear; 5 Chiefs of Naval Material since the position was established in 1963--Schoech, Galantin, Arnold, Kidd, and Michaelis; and 11 Commanders of the Naval Sea Systems Command, including the former positions of Commander, Naval Ship Systems Command, and Chief, Bureau of Ships--Mills, Clark, Wallin, Leggett, Mumma, James, Brockett, Fahy, Sonenshein, Gooding, and Bryan."[1]

The effect people can have on the acquisition strategy can be illustrated by the following:

In 1970, when Admiral Zumwalt became Chief of Naval Operations, he brought with him a ship procurement program referred to as Project 60 or the High-Low mix. In essence, this program was considered to reverse the trend in procurement of all expensive ships in small numbers, whose use is primarily to project American influence abroad, as in the Korean and Vietnam Wars. It was felt that there was a need for larger numbers of smaller, less expensive, less vulnerable platforms to protect the lines of communications. Here less vulnerable refers to the loss to the Navy due to the

loss of a single platform. When Admiral Zumwalt came to office, he saw as the current high cost ships: the LHA, CVN, DLGN (CGN), SSN-688 and DD-963. He decided to expedite the CVN, cut back the LHA program, which was already far behind schedule, and not to expedite the DD-963 or DLGN (CGN). The low portion of his programs included a 170 ton hydrofoil patrol boat, PHM, armed with a new weapon, the Harpoon missile system. It also included a small patrol frigate, PF (now FFG) to cost less than $50 million, and an "austere" carrier called the Sea Control Ship to cost $100 million in 1973 dollars or 1/8 the cost of a nuclear carrier.[2]

Admiral Zumwalt saw FY'74 as the first year in which he could approach Congress for approval of his proposed low-mix ships. Admiral Zumwalt felt that he needed support from one other party, Admiral Rickover. To achieve this support, Admiral Zumwalt agreed to request five ships in each of the first two flights of the SSN-688 project in FY'72 and '73. Admiral Zumwalt had planned on the CGN-36 through 40, but not the CGN-41 and 42. Admiral Rickover went to the home of the Secretary of Defense for dinner and personally swayed him to include $244 million more in the FY'75 budget for the CGN-41 and 42. Admiral Zumwalt was promised by the Secretary of Defense that this money would not come from ships already in the program, but, to date, only the FFG program remains a viable program, with the PHM program having only been re-instituted after a short period of inactivity.[3]

Another example of how people affect the acquisition strategy was given by Admiral Rickover in testimony before

the Appropriations Committee Subcommittee of the House of Representatives on how the AEGIS weapon system was to be deployed. He stated:

"Up to April 1971, Navy programs were based on all AEGIS ships being nuclear powered. It was planned to modify future VIRGINIA (CGN-38) class nuclear cruisers to accommodate AEGIS. In April 1971, Secretary of Defense Laird, under pressure from the Office of Management and Budget, cancelled the third NIMITZ class carrier, the CVN-70, and the two nuclear cruisers, CGN-41 and 42. He also cancelled the Navy's future plans for building AEGIS equipped nuclear cruisers. During the next two years, in response to the Congressional reaction, the Defense Department restored the CVN-70 and the CGN-41 and 42. Congress subsequently cancalled the CGN-42, ostensibly because it did not have the AEGIS system."

"In 1973, Admiral Zumwalt, who was then the Chief of Naval Operations, recommended starting a class of gas turbine powered AEGIS destroyers in FY 1977 and a class of modified VIRGINIA size nuclear cruisers with AEGIS in FY 1978. Secretary of the Navy Warner requested that the CNO investigate 'the feasibility of building a single new class of aircraft carrier escort, nuclear powered, vice the two now planned...' In a meeting I attended on 12 October 1973, Admiral Zumwalt chose a program of 16 gas turbine powered AEGIS ships and eight nuclear AEGIS ships to provide two AEGIS ships per carrier for a projected force level of 12 carriers, of which four were already authorized to be nuclear.

He said he based his decision on the assumption that all future carriers would be non-nuclear. This was a few months after his recommendation to plan on a fourth NIMITZ class carrier to be authorized in FY 1978 had been turned down and the Deputy Secretary of Defense had directed the CVX study I referred to earlier."

"Admiral Holloway became Chief of Naval Operations in July 1974, a month before Title VIII became law. Based on his review of future shipbuilding plans, he recommended that future carriers be nuclear powered. He also recommended, and the Navy adopted his position, that the Navy build 18 nuclear powered strike cruisers, CSGN's in lieu of the prior proposed mix of 16 non-nuclear and eight nuclear ships with AEGIS. He proposed that each of the strike cruisers be made larger than the VIRGINIA class in order to accommodate more weapons and to give the ships greater capability to operate independently as strike force units."

"In a letter of December 6, 1974 to the Seapower Subcommittee of the House Armed Services Committee, Admiral Holloway proposed a four-year program for building AEGIS ships. This program called for six nuclear powered strike cruisers, CSGN's to be authorized in the four-year period from fiscal 1977 through fiscal 1980, and no conventional AEGIS ships."

"The Navy subsequently recommended to the Secretary of Defense that, in addition to all new construction AEGIS ships being CSGN's, AEGIS should be introduced into the fleet by converting the nuclear cruiser LONG BEACH to AEGIS

as soon as possible. The Defense Department disapproved the 18 CSGN program and the LONG BEACH AEGIS conversion proposed by the Navy. The Navy continued to recommend that the first new AEGIS ship be a CSGN in FY 1977 with advance procurement funds in FY 1976. The Defense Department then cut the Navy's FY 1977 budget guidance by an amount equivalent to the CSGN and persuaded the Navy to recommend in the FY 1977 program a DD-963 type ship with AEGIS; this was named the DDG-47 class."

"However, in June 1975, President Ford disapproved this DoD/Navy recommendation to build a non-nuclear AEGIS ship. He amended his FY 1976 budget request to provide advance procurement funds in the FY 1976 budget for the first nuclear strike cruiser to be authorized in the FY 1977 program. The Congress did not authorize the long lead funds. The Navy program was then changed to four nuclear strike cruisers to be built over the five-year period FY 1977-81, along with seven conventional ships. However, by the time President Ford submitted his revised shipbuilding plans in early 1976, there were eight conventional AEGIS ships and only two nuclear strike cruisers to be built in this same five-year period. At that time, the five-year plan also included two nuclear carriers, both of which were ultimately dropped by the Ford Administration. Congress did not approve starting either the CSGN or DDG-47 programs in FY 1977. Instead, Congress directed that the existing nuclear cruiser LONG BEACH be the first AEGIS ship and appropriated $371 million in FY 1977 to start the conversion. Whether or not the LONG BEACH is converted to AEGIS,it will require an extensive overhaul and

partial modernization (estimated to cost about $264 million). The extra cost to give it a full AEGIS strike cruiser capability was estimated to be an additional $500 million. As you know, the LONG BEACH conversion to AEGIS has now been cancelled, and the $371 million appropriated in FY 1977 rescissioned."

"In January 1977, President Ford submitted a five-year shipbuilding program from FY 1978 through FY 1982, which included two smaller conventional carriers, two CSGN's and ten DDG-47 class AEGIS ships. The new Administration subsequently cancelled the nuclear strike cruiser program entirely."[4]

B. BIOGRAPHIES

To gain an insight to the positions taken by the major players within the Department of Defense, a look at their backgrounds will be beneficial.

1. Deputy Secretary of Defense Clements

Before entering into government service, Mr. Clements was chairman of an oil drilling company and was a director of the First National Bank of Dallas.

He first entered government service in 1969 as part of President Nixon's "blue ribbon" defense panel. He then became, in 1972, co-chairman for President Nixon's re-election committee in Texas.[5]

2. Admiral Rickover

Admiral Rickover assumed his present position in 1949. He is the Deputy Commander for Nuclear Propulsion,

Naval Sea Systems Command and he is also Director of the Division of Naval Reactors within ERDA.

To appreciate the status gained by Adm. Rickover the location of his two positions within their parent organizations must be examined. As can be seen from the Navy organizational charts, Exhibit 3, his office is low in the organization and he is a fourth level official within what was then the AEC, Atomic Energy Commission.

He was selected Rear Admiral in 1953. In 1962 President Kennedy extended him on active duty for two more years past the mandatory retirement age of 62. Since then, every two years Admiral Rickover has received an extension to remain on active duty.

3. Gordon Rule

Gordon Rule joined the Navy in 1942 as a Lieutenant and went to inactive duty in 1946 after being promoted to the rank of Captain. He returned to active duty during the Korean War and assumed the position of Deputy Director and Acting Director of the Contracts Division in the Bureau of Ships. He then returned to inactive duty as a reservist.

He authored "The Art of Negotiation" in 1962 which he donated to the Government and this publication is used as a textbook for training purposes by the Navy, Army, Foreign Service Institute and consultants teaching on behalf of the Department of Defense.

In 1963, he returned to the Navy as a civilian in the position of Director of the Procurement Control and

Clearance Division in Headquarters of the Naval Material Command. He retired at the end of 1976.

In November 1967 he was awarded the Navy Superior Civilian Service Award and in February 1971 he was awarded the Navy Distinguished Civilian Service Award.[6]

In 1972, when Adm. Kidd was Chief of Naval Material, Gordon Rule was asked to resign his position because of testimony he gave before Congress regarding the appointment of Mr. Roy Ash as Director of OMB, who at the time was President of Litton Industries. He refused to resign his position, so Adm. Kidd transferred him to a lesser responsible position. He was reinstated to his original position after intervention by Senator Proxmire.[7]

C. PEOPLE TO BUILD SHIPS

1. Labor

In the preceding sections, the uncertain atmosphere surrounding ship procurement and the three significant Government players were presented. NNSDCO's President J.P. Diesel must attempt to make long range plans in a volatile environment which poses many problems, especially with regard to labor. There are two major challenges to the shipbuilding industry: (1) Recruitment and retention of skilled labor and (2) the development of a manpower pool sufficient to expand operations.

It would appear that the number one problem facing all three of the largest Naval ship contractors, Newport News, General Dynamics and Litton, was the non-availability of

labor. Although in 1974 unemployment exceeded 6% nationally, unemployment in the local areas of these yards was a low 3%. The results of this situation were described by the president of Ingalls Shipbuilding Company (Leonard Erb) when he said that if a local loses his false teeth at a neighborhood bar, he comes to work for Litton until his problem is solved and then quits.[8] All three of these major builders expanded operations in the early '70's. Litton more than doubled its capacity at Pascagoula, Mississippi, to become the largest shipyard in area in the United States.

Tenneco's expansion of the Newport News yard, while not as large as the Pascagoula expansion, took place in an area with much higher competition for labor. In order to meet Newport News goals for the shipbuilding yard, it was necessary to increase from 25,000 employees in 1972 to 33,000 in 1974.

Hiring problems were already apparent in 1971 and 1972 when recruiting from the local and middle Atlantic area resulted in filling only 68% of the shipyard's vacant positions.[9] Skilled occupations must almost totally be recruited locally, as these individuals do not like to relocate. There are two major local competitors for skilled workers, particularly, welders, shipfitters, and pipefitters, namely the Naval Shipyard Norfolk and local construction.

The Tenneco Company claims that the Government owes $32 million in claims for unfair naval shipyard recruiting practices. Admiral Rickover says that this figure amounts to $42 thousand per recruit, which would pay for a Harvard

education.[10] Wages are 11% higher for the skills in the naval shipyard and 30% higher in civilian construction.[11] The Navy yard also offered greater job security. High housing costs in the Newport News-Hampton area could easily account for one fourth of a worker's pay and is a driving force to seek employment at the higher wages.

These conditions also result in a high turnover rate. In order to maintain the status quo, Newport News in 1973 was required to hire 5 to 6 percent of its critical skill occupations per month. This turnover rate was such that Newport News lost an equivalent of 58% of the productive labor hired compared to an industry wide 50%.

Dilution of average skill level was expected with expansion, but when coupled with this high turnover rate, had a more than normal effect on shipyard operation. It was noted by some Naval personnel that those supervising at the middle levels one year were by necessity moved to more responsible positions and often their replacements were not visible. Contrary to normal learning experienced in the past, the contractor was expending increased productive man-hours on submarine refueling to accomplish non-nuclear work packages on successive contracts. A comparison of the non-nuclear labor return for SSBNs 628, 629, 636, 641 and 645 support this statement. Where learning had been pronounced between the first and second submarines, it ceased at that point, and additional labor was required on each successive ship. SSBNs 628 and 629 were completed prior to the labor expansion and actually experienced labor under-runs of 88,000 man-hours,

whereas, the remaining three experienced overruns amounting to 176,000 man-hours.[13]

In 1973, DCAA reported that this decreasing productivity would result in overruns of 1.7 and 1.3 million man-hours on the DLGN 36 and DLGN 37 and 8.2 million on the CVAN's 68 and 69 and overall would result in an increase in cost to the Government of $89 million. In 1971 and 1972, recruitment costs of $642 thousand were spent merely to cover losses, while $2.8 million of training costs were lost as a result of employee turnover. Additionally, subcontracts required by nonavailable labor increased Government costs by an estimated $500 thousand.[14] While Newport News has one of the largest and most comprehensive training programs of all private shipbuilders, it proved insufficient to meet the demand. Over the two year period of 1972 to 1973, Newport News hired some 18,000 people, but in the same period lost 17,000 employees.

From a low in 1971, when Newport News had 18,000 employees, in 1973 they reached a high of 27,000. It was then decided that increased employment was impossible.[15] On 11 September 1974, the Daily Press (Hampton Roads Morning Newspaper) carried the story, "Yard Asks 16,000 to Work Six-Day, 48 Hour Week," in which more than 16,000 maintenance and production workers were asked to voluntarily work 48 hours a week "in the...hope that this additional production time will help us meet our shipbuilding scheduling objectives." The article further quoted the then Newport News president,

J. P. Diesel as saying before the U.S. Senate Seapower Subcommittee that a number of ships under construction "are seriously behind schedule in terms of original contract delivery dates." But he also added that the so called manpower problems were caused by an inability to utilize his people efficiently and effectively. He went on to say that they were planning their work but not working their plan because of delays, defective equipment and components (some of it government supplied), lack of material, and similar matters.

2. Navy Concern over Labor

In the fall of 1972, when Newport News announced plans to build the commercial yard for subsequent construction of the three LNG's, the shipyard had nearly the 27,000 employees. The Navy was told that the employees would be used in the Navy 1974 program. In a policy letter dated 12 February 1973, Tenneco again stated that they would not allow performance on non-Navy contracts which would interfere with performance on Navy contracts.

The Navy felt that the low productivity was increasing the man-hours required to do their work and the Navy Supervisor of Shipbuilding Conversion and Repair, Newport News (SUPSHIPNN) noted in a letter to Newport News that the direct labor being assigned to Navy new construction in 1975 was 1000 men less per day than in 1974, and that although changes had been kept below previous years, this gross undermanning had been a major cause to continuing delays in Navy new construction. From January 1975 to December 1975, labor

on Navy new construction had declined from 14,005 to 12,674, while labor on commercial work rose from 1,213 to 3,021 men per day. Mr. Diesel repeatedly assured the Chief of Naval Material and the Commander, Naval Sea Systems Command, that he would provide long range man-power projections for Navy work, but they were never furnished. Admiral Rickover feels the decrease in productivity increased the amounts of rework and that the labor shortage led Newport News to stretch out Navy ship construction schedules. On this basis, he concluded that, under the shipbuilding contracts, the resultant costs of escalation and deferred work were the responsibility of the shipyard.

On the other hand, Mr. Diesel testified before the House Armed Services Committee on Seapower in 1974, utilizing the construction of the CVN-68 Nimitz as an example, that the original ship design contract signed in 1967 called for ship delivery in September of 1971, but due to material and design problems, the construction contracted for in September 1971 was for delivery in June of 1972 or September of 1973. Labor planning was disrupted by the late delivery of the nuclear reactor components and the requirement to maintain deck openings for the later installation. Admiral Rickover argues that allowances for these deliveries could have been more properly managed. The CVN-68 was not commissioned until 1975.

3. Other Significant Problems Involved in Long Term Program

Other significant problems facing Newport News in long construction periods are material availability, sole source

subcontractors, unpredictable inflation (which reached double digit in the early 1970's), inflation of shipbuilder's costs (which were double that of almost all other industries), and the high cost of financing. There is seldom a research and development phase in shipbuilding. "Fly before buy" does not seem to apply; this means that there is much concurrency in ship design and construction, resulting in inevitable rip-out and modification. Newport News is in agreement on this for the lead ship of a class, where time will not permit the building of a prototype, testing it until all are confident that it works, and then ordering other production models. The shipyard therefore repeatedly recommends cost type contracts on the first ships of a class, which would alleviate much of the risk and burden of the above problems.

D. THE NUCLEAR BURDEN

The fact that a ship will be nuclear powered causes them to fall into a completely separate routine, one that requires much greater supervision and management. Nuclear propulsion drawings are the only ones which are non-deviation, meaning that the builder must build things as in the drawings, even though they may be wrong in the eyes of the builder. Qualifications for laborers are much greater for nuclear powered vessels. Repetition and detail of testing are also much more extensive.

Participating in the nuclear testing are the ships' force, because they are the only licensed operators in the yard. This provides a fourth set of inspectors, the first being

the shipyard, the second being the SUPSHIP, the third being the AEC working for Admiral Rickover directly, and fourth being the ship's force.

Safety requirements are understandably greater and an impact on construction management. The thing that most characterizes a nuclear ship is the lack of compromise. The rule must be followed to the letter, and there is no exception. This requirement seems to be demanded without question in the power stations throughout the country, but perhaps the excellent record of our nuclear ships has abated the fears of nuclear accidents occurring in ship construction.

IV. CGN-41 BACKGROUND

In this chapter, background details pertaining to the contract for the CGN-38 class ships and the events leading to the parties entry into court will be explored. First, emphasis is placed on the roles of the U.S. Navy and Newport News Shipbuilding and Drydock Company (NNSDCO). Then, additional information is provided showing the influence of Congress and high officials within the Department of Defense with respect to this case.

A. OPTION FORMULATION

On June 25, 1970, the Navy entered into a contract (Contract N00024-70-C-0252) with NNSDCO for the preconstruction preparation necessary for the construction of the nuclear guided missile frigate, DLGN-38 (later to be designated the CGN-38). This contract also contained an option, which could be exercised by the Navy, for the actual construction of the DLGN-38.

The scope of the initial contract was expanded by contract modifications. These modifications altered the terms of the original contract and the most significant changes came with modifications P00007, P00018, P00024 and P00037.

1. Contract Modification P00007

In February 1971, the Navy went into negotiation with NNSDCO. The result of the initial negotiation was a decision

to build five ships of the CGN-38 class. In April 1971, with orders from the Deputy Secretary of Defense, the Navy, in negotiation with NNSDCO, proposed to reduce the number of the CGN-38 class from 5 to 3. In July 1971, NNSDCO made a counter proposal, consisting of 3 ships to be built and an option (exercisable by the Navy) for 2 more. Agreement on this proposal was reached in November 1971 by both parties.

On November 22, 1971, NNSDCO returned the contract modification for the above proposal, but included a document which they claimed was the minutes of the negotiations. The Navy, upon review of this included document, refused to finalize the contract because of errors in the supposed minutes. NNSDCO agreed to withdraw the document, but the Navy would not agree to the contract until an affidavit was filed stating that the document was erroneous. After discussions between the President of Tenneco and the Navy, NNSDCO agreed to (and signed) a letter which stated the document was in error. Copies of these supposed minutes were to have been destroyed, but NNSDCO later makes reference to these same documents in arguments of coercion on the part of the Navy.

Contract modification P00007 was executed on December 21, 1971. By executing this change, the Navy contracted for the construction of the CGN-38, plus two additional ships of the class (CGN-39 and 40). In addition, a specification was included which gave the Navy the option to contract for two more ships (CGN-41 and 42). The important specification is Article 28 of Contract Modification P00007. The options

were to be exercised by February 1, 1973 for the CGN-41 and by February 1, 1974 for the CGN-42.

2. Contract Modification P00018

On February 1, 1973, the Navy and NNSDCO executed Contract Modification P00018. When this modification was executed, the Government felt that Article 28 had been amended such that the option exercise dates for the CGN-41 and 42 had been extended by two years. One option which the Navy purported to exercise states:

> "On or before 1 February 1975, the Government, by modification to this contract, may require the contractor to construct and deliver CGN-41, but only if the Government, by modification to this contract by December 1, 1973, authorizes the contractor to expend funds in an amount of $29,062,200 for material procurement, shop fabrication, and other preliminary work."

Details of contract modification P00018 are included in Exhibit 3.

3. Contract Modification P00021

On November 29, contract modification P00021 was executed. With this modification, the Government maintained that the delivery dates for DLGN-41 and 42 were extended to October 1978 and June 1979, respectively, in return for an extension of the date by which the Navy must provide funding for the preconstruction work on DLGN-41 and 42, in order to exercise the options for actual construction.

The Navy executed contract modification P00022 on February 27, 1974. This modification authorized NNSDCO to spend $35 million to accomplish the preconstruction work on the CGN-41. The bulk of this authorization was a prerequisite under Article 28 of the original contract.

Contract modification P00024 was executed by the Navy on January 31, 1975. With the execution of this modification the Navy exercised its option for the construction of the CGN-41.

B. NAVY-CONTRACTOR RELATIONS

During the first few years of the contract, the Navy and NNSDCO had a good working relationship, but after contract modification P00022 was executed, their relationship became hostile. In December 1974, NNSDCO submitted to the Navy a document outlining areas which they felt made the exercising of the option to construct the CGN-41 and 42 invalid. The areas presented were:[1]

1. Invalidity of option caused by specification changes. NNSDCO stated that under the original contract, the CGN-41 and 42 were to be follow ships of the CGN-38 class. Because of the numerous change orders and constructive changes issued by the Navy to the CGN-38 through 40 (which had not been applied to the CGN-41 and 42), the CGN-41 and 42 were no longer follow ships.
2. Invalidity of option caused by commercial impracticability. NNSDCO stated that because of market conditions, material shortages, severe inflation, etc., performance of the CGN-41 and 42 contract would entail losses critical to the company and that this option was unenforceable.
3. Invalidity of option caused by mutual mistake of fact. NNSDCO stated that both parties were mutually

mistaken in the assumption that the maximum price of CGN-41 and 42 would be sufficient considering economic conditions (i.e., high rate of inflation).

4. Invalidity of option caused by unilateral mistake as precluding option exercise. NNSDCO stated that an option is merely a unilateral offer and does not ripen into a contract until accepted. Therefore, the contractor is entitled to rescind its offer.
5. Invalidity of option caused by unconscionability. NNSDCO stated that the present ceiling prices for the CGN-41 and 42 are ruinously low because of the lifting of price controls and high inflation.
6. Illegality of option provisions because they are in violation of Armed Services Procurement Regulations (ASPR). NNSDCO bases their position on the fact that the ASPR authorizes the Government to prescribe options only when the prices will not be unfair to either party and that the contractor would not be forced to incur undue risks. It now is clear, in NNSDCO's opinion, that the criteria for inclusion of the options were not fulfilled and must be deemed ineffective.
7. NNSDCO stated that the illegality of the extension and exercising of option was that there was no statutory negotiation authority for the CGN-41 and 42 and it was not supported by a proper D&P; therefore, the Navy's option rights could not be extended and the options were invalid.

8. NNSDCO stated that there was not adequate new legal consideration to support modifications which extended option exercise dates.

9. NNSDCO stated that options were unenforceable because maximum ship prices have been rendered grossly inadequate because of the economic situation.

10. NNSDCO stated that options were indefinite because numerous changes to conform the CGN-41 and 42 to the CGN-38 (so as to make them follow ships of the class) had not been made. This resulted in undefinitized, unfixed and unknown prices.

11. NNSDCO stated that existing economic conditions and material shortages may doom to failure the contract because of inadequate pricing. Such failure would be excusable because of factors beyond the control and without the fault of NNSDCO.

The Government carefully reviewed the NNSDCO document and all 11 allegations,[2] and found no validity to any of these arguments. There existed an escalation clause to cover increased costs for material and labor. By definition, the CGN-41 and 42 were still follow ships of the CGN-38 class. Even though all changes had not been incorporated into the CGN-41 and 42, none of these changes significantly altered the design of the ship.

C. MEMORANDUM OF UNDERSTANDING

Because of the increasing hostility between the Navy and NNSDCO, a "Memorandum of Understanding" was signed by both

parties in February of 1975.[3] Under this memorandum, both parties agreed to a cooling-off period during which they would refrain from initiating any court action. Further, negotiation was to continue without prejudice to the rights of either party.

D. RICKOVER ASSESSMENT

Admiral Rickover, in February 1975, assessing the CGN-41 negotiations, made the following comments and recommendations:[4]

1. The present difficulty with NNSDCO stems from the fact that they have been able to discuss the problem with senior Department of Defense personnel and Navy officials who can apply pressure to the Navy to settle.
2. The Navy is in good legal position regarding the option and should not make any concessions. Any special consideration given NNSDCO on the CGN-41 could have ramifications on the contract for the CGN-38, 39, and 40.
3. No notification was given to the Navy prior to announcing the construction of a new commercial yard. NNSDCO has assured the Navy in writing that they will not allow commercial work to interfere with Navy work, but the assignment of shipyard personnel to have responsibility in two areas must have an impact.
4. NNSDCO wants to delay the CGN-41 by 19 months and the CGN-42 by 23 months. This could be an attempt

on their part to reprice the contract as well as divert skilled manpower to commercial work.

5. NNSDCO complains of high interest they must pay on money used to finance Navy work, but as of February of 1975, NNSDCO had reported costs of $1,471 million and had been paid $1,408 million.

NNSDCO contention that the option exercise was invalid did not stop when the Memorandum of Understanding was signed. Early in April of 1975, a senior official of NNSDCO sent a letter to the Navy citing three reasons why the CGN-41 option was invalid.[5]

1. The option exercise is prohibited by the Anti-Deficiency Acts. NNSDCO contended that the monies appropriated in the 1975 budget were not sufficient to cover the ceiling cost of the CGN-41 contract and DoD had granted a waiver for full funding and NNSDCO cannot proceed until it is guaranteed of full funding.
2. The option exercise was not authorized by the 1975 Appropriations Act. NNSDCO contends that the CGN-41 is not a follow ship to the CGN-38 class because of substantial changes that had not been incorporated, but to incorporate these changes would require NNSDCO to make new designs at a substantial cost.
3. The option exercise is prohibited by ASPR. NNSDCO contends that because, in their estimation the program is not fully funded, it is prohibited by ASPR to exercise option.

The Navy, in response to these allegations, once again stated that the option to build the CGN-41 was valid. The Navy stated that sufficient funds had been appropriated for the obligations under contract. The CGN-41 and 42 have the same basic characteristics of the CGN-38.

E. NAVY ANALYSIS

In addition, the Navy prepared an analysis of the CGN-41 case for the Under Secretary of the Navy,[6] which reviewed the debate on the validity of the option plus the major points of a new NNSDCO proposal. The major point of this new proposal was the change in the delivery dates for the CGN-41 and 42, which was to delay the delivery by 19 and 23 months, respectively. The analysis of the situation was as follows:

1. NNSDCO contends that delays are due to problems with contractor furnished equipment. The NAVSEA negotiators have concluded that NNSDCO has not taken reasonable action to procure machinery components on a minimum schedule and the responsibility lies with NNSDCO to take aggressive action to minimize the impact on cost and schedule.
2. To avoid problems in building the CGN-41 and 42 on contract schedule, continue Navy work in progress, contract for future cost type overhaul work, and deliver commercial work on schedule, NNSDCO must reverse decreasing manpower levels and build up from 18,000 to 22,000 direct labor personnel. NNSDCO, by delaying the work on the CGN-41 and 42, would eliminate need

for 1000 to 1500 direct labor personnel in the critical period of 1976 and early 1977. If NNSDCO postpones the delivery of the CGN-41 and 42 to their proposed dates, this would reduce manpower buildup required to make manpower available for commercial work through the critical period, plus guaranteeing work in the 1978 to 1980 time frame.

3. NNSDCO has repeatedly contended that they would suffer large losses if the CGN-41 and 42 were built according to the contract, but have never submitted any documented proof. According to Navy estimates, they stand to make a $4 million profit under contract with their proposed delivery dates.

4. Answers were also provided for specific allegations made by NNSDCO:

   a. NNSDCO alleged that the Navy's delay in authorizing them to expend funds for long lead time procurement impacted on their ability to procure these items. According to the Navy, extensions on these dates were agreed to by bilateral contractual agreement and funds were provided by the Navy on the dates specified.

   b. NNSDCO alleged that they could not extend their vendor options as it did not have funding authorization from the Navy. The Navy stated that these options were originally obtained without funding authorization and NNSDCO could have offered extension in delivery dates, as well as

escalation coverage, as the Navy did with NNSDCO.

c. NNSDCO alleged that in early 1974 the Navy was informed of problems in procuring long lead time material and had been asked for assistance, but had not responded. The Navy stated that they had been informed of increasing prices and of vendors refusing to honor option exercises, but had not been informed of the problem of obtaining material in time to complete construction to the contract date.

F. THE AEGIS OUT

In May 1975, because of the position taken by NNSDCO in regards to the option for the CGN-41 and 42, the Under Secretary of Defense requested that the Navy study the possibility of delaying both the CGN-41 and 42 until the AEGIS weapon system was available for fleet use. Though this would not eliminate the whole problem, the Chief of Naval Operations recommended that both ships continue to be built as originally configured. In the Congress, the Senate Armed Services Committee voted to delay the CGN-42 until the AEGIS system was available, while the House Armed Services Committee voted to continue with the CGN-42 as planned. Admiral Rickover presented his position for building the CGN-41 and 42 as planned in the following arguments:[7]

1. By 1981, there will be 4 nuclear aircraft carriers and only 10 nuclear powered missile ships, including

the CGN-42. The weapons system for the CGN-38 class is superior to existing systems, when the AEGIS weapon system reaches the fleet, it will enhance the capability of the CGN-38 class weapon system.

2. It is not the intention of the Navy, to the best of his knowledge, to include AEGIS on all carrier escorts, but rather on 2 escorts per carrier. These escorts would be used in conjunction with other existing missile ships for good defense. Therefore, the Navy may wish to use the CGN-38 class as configured throughout their lives or in later years modernize the CGN-38 class with the AEGIS system under a modernization program. Studies have shown that money can be saved by building now what is under contract and modifying later rather than to delay until development is complete.

3. If the CGN-42 is delayed to allow incorporation of the AEGIS system, it is possible that funding will be lost and this could in effect cause the loss of the CGN-42.

4. If the Navy now says that building the CGN-42 as presently configured is no longer valid, then the CGN-41 may come under attack and be deferred also because the keel has not yet been laid down. Thus, it is quite possible that the Navy could lose both the CGN-41 and 42.

5. During the period FY'63 through FY'76, only 7 new fleet air defense ships (nuclear or non-nuclear) have been

approved. The CGN-36 to CGN-42 and the Navy should not take any actions which may jeopardize any of them.

G. THE NAVY'S MAXIMUM POSITION

In the last part of May 1975, the Navy outlined its maximum acceptable position in regard to the CGN-41 and 42.[8] In this, the Navy set a ceiling price of $100 million for the CGN-41 and $99 million for the CGN-42. The Navy had developed their maximum position from data submitted from NNSDCO. The details of the Navy's position are shown in Exhibit 4.

H. MAXIMUM SHIPYARD POSITION

In June 1975, a representative of NNSDCO went to Washington and met with a member of the Navy's contracting officer's staff to further discuss the CGN-41 contract, hoping to persuade the Navy to change their position. NNSDCO representative pointed out that the number of shipyards in the United States capable of building nuclear powered ships had dropped from 7 to 2. He then made the following points, emphasizing that NNSDCO would not build a ship at a loss:

1. NNSDCO wanted to change the delivery date for the CGN-41 from October 1978 to May 1980. This extension is due to the failure to achieve option dates because of the Navy's failure to resolve baseline technical problems which delayed placing long lead time items under contract in timely fashion.
2. NNSDCO required that the ceiling price be raised to $125 million from $100 million. This would not

include any escalation provisions, but would include all changes and a release to date from claims.

3. NNSDCO required that escalation coverage extend to new delivery date with billing to new ceiling.
4. NNSDCO wanted the CGN-42 to be subject to separate pricing action.
5. NNSDCO does not recognize the option to build the CGN-41 and 42, but wants a separate contract for these ships. They do not recognize the Navy delivery needs and are unwilling to accept any responsibility for higher prices. They further stated that "NNSDCO will not accept any work that will not put them into the black."
6. The NNSDCO representative stated that if agreement cannot be reached on the CGN-41 (and 42 if approved by Congress), NNSDCO may not build the ships, and if Mr. Freeman (President of Tenneco) has his way, NNSDCO will withdraw its offer on SSN-688 procurement. In addition, NNSDCO may pull its men off all other Navy work, including CVAN and would fight by legal means if forced to do work.

I. CGN-41 WORK SUSPENDED

Late in August of 1975, NNSDCO informed the Navy that the maximum acceptable position put forth by the Navy would cause a $38 million loss for NNSDCO and that NNSDCO was under no obligation to construct the CGN-41 for the reasons they had put forth earlier:[10]

1. Adequate funds were not appropriated to effectively exercise option on the CGN-41.
2. Ship specifications have not been kept up to date, so CGN-41 is not a follow ship.
3. Issues such as commercial impracticability still have not been resolved.
4. The impact of the construction program for the CGN-38, 39 and 40 have not been contractually reflected on the CGN-41.

It was further asserted that, even if the option were valid and enforcable, the maximum acceptable position did not recognize NNSDCO's contractual rights concerning vessel delivery dates, escalation, changes in law and other matters. In addition, the Memorandum of Understanding was cancelled and all long lead time procurement and other work pursuant to the CGN-41 were suspended.

V. CGN-41 IN COURT

This Chapter provides the details of the CGN-41 court case and in particular, the evolvement of the division within the Government resulting in the appointment of Mr. Gordon Rule.

A. ENTERING COURT AGREEMENTS

On 27 August 1975, Newport News halted all work on the CGN-41. On 29 August 1975, the Navy (represented by the Justice Department) filed suit in the U. S. District Court for Eastern Virginia, Newport News Division, seeking a preliminary injunction and a temporary restraining order to order Newport News back to work on the CGN-41.

The position presented by Newport News before the court was that the option was invalid for the following reasons:

1. There were insufficient appropriations, which was a contravention of 41 USC 11(a), 31 USC 11 665(a) and the Armed Services Procurement Regulations (ASPR).
2. The Navy had failed to notify the Shipyard of the specifications for the CGN-41.
3. Under various legal theories, the option was unenforceable, e.g., commercial impracticality.[1]

In court on that same day, Newport News suggested and the Navy agreed to an arrangement whereby for one year, unless terminated by either party giving prior notice, Newport News agreed to continue work on the CGN-41 and the Navy agreed to

pay for work done under this agreement on a cost plus 7% fee basis. During this period, both parties further agreed to negotiate in good faith to settle the option controversy and to seek an expeditious opinion from the Comptroller General on the question of insufficient appropriations previously submitted by Newport News. Both parties asked the court to allow this argument to be read into the record of the court as an Order of the Court. The Court, "believing that all good faith attempts to reach settlement should be encouraged,"[2] agreed. In the court's opinion, this order by the court mooted the temporary restraining order issue and stayed the judicial proceedings. It was directed that Newport News immediately resume preconstruction work and proceed to undertake construction of the CGN-41. All changes heretofore made in the specifications for the earlier CGN-38, 39, and 40 were to be considered as incorporated into the specifications for CGN-41 and the parties agreed to negotiate in good faith the appropriate equitable adjustments for all specification changes.

Important to the case was the language of this agreement where the parties agreed to "negotiate in good faith to reach an agreement as rapidly as possible to modify those contract provisions requiring amendment or to take other appropriate actions."[3] At the day of the agreement, Mr. Jeffery Axelead (representing the United States and the Department of Justice) stipulated to the Court that E. Gray Lewis (the Navy's General Counsel) would "undertake to ensure the Navy's obligation" to negotiate under the court order.

B. TO NEGOTIATE OR NOT TO NEGOTIATE

On 29 October, Mr. Lewis was ordered by higher Navy officials to stop all negotiations. On 30 October the Acting Commander, NAVSEA, formally recommended to the Assistant Secretary of the Navy (Installations and Logistics) that the Navy amend its complaint before the Court and obtain a ruling on the option validity. He stated that he considered any delay to be disadvantageous to the Navy and that inaction would leave the Navy open to charges of acquiescence to intentions to delay delivery of the ship. In NAVSEA's opinion, Newport News had not changed their position that new contract terms and conditions were required. He stated further that, "There is no basis to modify the maximum Navy position of the May 28, 1975 letter to Newport News. The Navy has a good case and further delay will obscure the situation."[4]

C. CGN-41 STEERING GROUP

On 31 October 1975, the Under Secretary of the Navy (I&L) established a CGN-41 steering group to oversee the negotiations. Members included the Under Secretary of the Navy, the Assistant Secretary of the Navy (I&L), the Chief of Naval Material, the General Counsel of the Navy, the Commander, Naval Sea Systems Command, and Admiral Rickover. Rear Admiral S. J. Evans, the Deputy Chief of Naval Material was appointed head of the Navy's negotiating team.

Admiral Evans' charter included the following objectives:

(a) Comply with the spirit and letter of the District Court Order of 29 August 1975.

(b) Negotiate to achieve construction of the CGN-41 in accordance with the terms of the contract between the Navy Department and Newport News, including such modifications required by the terms or otherwise authorized by law or Armed Services Procurement Regulations.

(c) Achieve resolution of outstanding issues of the CGN-41 option between the Navy and Newport News at the earliest practical date.

(d) Obtain stipulation by Newport News of CGN-41 option validity under any settlement achieved (pursuant to (a) above).

(e) (Concurrent with good faith negotiations under (a) above) assure that all necessary and proper arrangements have been made to pursue the CGN-41 controversy in the appropriate legal form, as may be in the best interest of the Navy.[5]

D. TO DECIDE NOW

18 November 1975, Admiral Evans recommended that the Navy request that the Justice Department file papers to obtain the Court's ruling on the validity of the CGN-41 contract. The recommendation was disapproved by the Assistant Secretary of the Navy (I&L), who, in a memorandum to Admiral Evans on 19 November stated that the timing was "inappropriate now," that a good atmosphere was needed for negotiations as required by the Court. Admiral Evans was urged to bend all efforts to reach a settlement.[6]

In February 1976, Newport News had submitted several new claims. The Deputy Secretary of Defense, Clements, subsequently instructed the Navy within 30 days to come up with a plan that would both improve relations with the shipbuilder and resolve outstanding disputes.[7]

E. RULE ENTERS

Also, on 30 October, Mr. Gordon Rule, head of the Procurement Control on Clearance Division within the Naval Material Command, made a speech alleging misbehavior on the part of many high level civilians and military in the Department of Defense, calling for those involved in major procurement to be summoned before Congress and required to testify under oath. Most notably, he also recommended that Admiral Rickover be kept on active duty, "no matter what anyone thinks of him, (he) knows what he is doing and does it well."[8]

On 4 March 1976, Gordon W. Rule signed a document which appeared in the Shipbuilder's Council of America Newsletter, in a letter from J. P. Diesel to Congressman Downing, and ultimately in the Congressional Record for 18 March 1976. The major question posed by this Article, "Navy Shipbuilders of America" was: Where will the Navy find the shipbuilding capacity to produce our known requirements for ships, when we have no mobilization base in the United States for Navy shipbuilding? Mr. Rule feels that the Navy plays games and places ships in predetermined yards under the guise of competition. He also points out that, prior to 1963, the Navy had allocated ship construction to keep yards busy, but that this practice was dropped in favor of competition.

The minor premise of this article was that, if the capacity could have been found, under what terms and conditions would it be available to the Navy. Mr. Rule felt that it was necessary that the Navy not use the Defense Production Act and that the shipbuilding industry be assured of fair contracts and treatment by the Navy and of a reasonable opportunity to earn a good profit.

Mr. Rule also identified the following points to understand in dealing with the shipbuilding problem:

(a) Shipbuilding involves concurrent development and production.

(b) Concurrent development leads to changes.

(c) When the Navy utilizes lead/follow yard methods, claims and delays are inherent.

(d) Shipbuilding labor is 30-35% nonproductive or inefficient.

(e) The Navy makes unfair contracts for building the ships it requires and industry knows this.

(f) Unfair contracts leads to claims.

(g) A review of Claims and Requests for Equitable Adjustment indicates that the Navy is not learning.

(h) That the Navy went to court against Newport News and was told to negotiate differences.

Mr. Rule went further in recommending a short term goal of settlement of the outstanding Litton and Newport News claims, but more important for the long run goal, it was his feeling that the Navy must change from the firm fixed

price, FFP, and firm fixed price plus incentive fee, FFPI, contracts. Other specific recommendations were: (a) the return of allocations to private yards, (b) creditable target prices, which had a 50/50 chance of being met, and (c) that lead ships be started on a cost-no-fee contract to be later definitized to a FPI contract.

Admiral Rickover has stated that these arguments by Mr. Rule set the tone for subsequent contentions of shipbuilders and Senior Defense Officials that Navy contracts were unfair.

On 22 March 1976, Gordon W. Rule issued an addition to his 4 March article in which he included the statements of Newport News President Diesel and General Dynamics Electric Boat Division President, Mr. Pierce. Mr. Diesel stated that the Navy's primary problem was whether or not there was going to be a private sector to do the Navy's shipbuilding. Mr. Pierce was quoted to the effect that things had gotten worse since Electric Boat had chosen nuclear submarines as their only work and that they were not going to let the Navy run their businesses.

To eliminate claims, Rule again recommended the two-step contract procedure where he felt pricing problems would be forced to the foreground and not left to later controversy. After pointing to the manpower diverted to negotiation of claims, he proposed full pricing at issuance of all change orders. He also opened the subject of possibly paying interest on claims.

F. MR. CLEMENTS AND P.L. 85-804

On 24 March 1976 DEPSECDEF Clements received a presentation by the Navy on a plan to resolve the dispute with Newport News. Admiral Rickover has testified to Congress that Navy representatives had concluded that there was no quick way to settle claims in accordance with the contract terms. However, just prior to this presentation, Senior Navy Officials decided to present only alternatives, with no recommendations. One of these alternatives was the use of Public Law 85-804. Admiral Rickover felt strongly against this decision, insisted on putting his recommendations in writing, and presented them directly to the Deputy Secretary Clements. Despite Admiral Rickover's strong protest, Mr. Clements chose to attempt resolution through P.L. 85-804.

In a memorandum to the Chief of Naval Material on 29 March, Rule stated support for a Deputy Secretary of Defense Clements decision to utilize PL 85-804 to erase the $1.7 billion in claims of Electric Boat, Litton and Newport News. He stated that $1.097 billion were for nuclear ships and predicted a "head to head" confrontation with Admiral Rickover. He recommended that lawyers be included in meetings on this issue and that whoever was to lead the group should not have had any past experience with the yards in question.

On 30 March 1976, DEPSECDEF Clements, after stating that the status of shipbuilding was unsatisfactory and describing an atmosphere of sharp litigation and mutual distrust, declared that PL 85-804 must be used. To accomplish this, he

established the Shipbuilding and Executive Committee comprised of ASD(I&L), ASD (Legal Affairs), the General Council of DoD, ASN (Financial Management), CNM, and COMNAVSEA. Noticeably absent was Admiral Rickover.[9]

G. ADM. RICKOVER VS. MR. RULE

On 28 April 1976, Admiral Rickover submitted a memorandum to the CNM in reply to Rules' Article of 29 March in which he stated that:

1. Gordon Rule had failed to mention items of contractor responsibility that caused cost increases, increased overhead rates, lower productivity, inadequate manning, and construction errors.
2. Escalation provisions and progress payments are more liberal in shipbuilding contracts than in any other defense contracts, and in addition, the Navy takes responsibility for many of the high risk items through the providing of Government Furnished Equipment (GFE).
3. There is mutual agreement on type of contract, delivery dates, and target costs, and that Mr. Rule had sat in on these negotiations and reviewed all of the contracts.
4. The contractor was well protected by the escalation clause as long as he worked within the contract delivery date and ceiling price.
5. It takes time to evaluate and negotiate. Navy procurement directives require that the contractor certify

that a claim is current, complete and accurate. Newport News refused to do this.

6. The bulk $665 million of the Newport News claim for $894 million had only been submitted within the last year.
7. A cost-no-fee contract would put the Navy in a bad bargaining position.
8. Gordon Rule recommended excusing shipbuilders on the basis of poor Navy procurement practices on contracts which ignored the fact that some shipbuilders have been unwilling to settle claims on the basis of legal entitlement.

On 14 April 1976, Gordon Rule listed the following as causes of the Navy problems.

1. Price competition for warships.
2. Forward pricing of fixed price contracts.
3. Use of unrealistic delivery dates.
4. Misjudging the economic impact of normal and abnormal inflation on ship contracts.
5. Wrong types of contracts.
6. An unfair matrix of contracts.
7. Unfair and inappropriate escalation clauses.
8. Contracting to meet budget estimates.
9. Late Government furnished equipment and information (GFE and GFI).
10. Failure of the Navy to properly recognize a nation-wide shortage of a shipbuilding labor force.

Rule's recommendations for improvements to be incorporated in future relations included:

1. Realistically assessing the risk involved in concurrent development and production and discontinuing the use of fixed price contracts where they had proven to be unrealistic, imprudent, and claim producing.
2. Allocation of shipbuilding and overhauls.
3. Building lead ships under cost type contracts.
4. Not contracting for a class of ships until one or two had been built.
5. Allocating work on a cost contract and on a specified date converting to a fixed contract for follow on work.
6. Requesting from Congress, at the outset, additional funds when required, rather than waiting.
7. Establishing a 50/50 chance target cost.
8. Doing away with unilateral changes.[10]

In a letter to United States Congressman Melvin Price, dated 10 May 1976, Mr. Rule stated that the situation required "surgery, not treatment" and that the claims were not the problem but rather a result of the problem. In this letter he outlined a three step following for solving the problem:

1. Use of 85-804, as recommended by DEPSECDEF Clements, to eliminate the existing claims.
2. Reestablishment of mutual respect between the contractors and the Navy.
3. Use of fair shipbuilding contracts.

Mr. Rule also stated that the major roadblock was Admiral Rickover, whom he felt was unwilling to accept a decision from a superior. He further stated that Rickover should have been removed from all contractual matters, remaining in a technical consultant position only.

H. MORE PRESSURE

14 June 1976, Newport News formally advised the DEPSECDEF that it considered that the Navy had breached its contract option for construction of the CVN-70 VINSON. Similar to the CGN-41 case, this option was part of the original CVN-68-69 contract. Terms of this contract were to be definitized by December 1974, but as of 5 July 1976, Newport News felt that no action had been taken; therefore, they intended to stop work on the CVN-70. Litton then notified the Navy that they intended to stop work on the LHA project, also holding that the Navy was in breach of contract.

On 18 June 1976, Newport News Vice President C. E. Dart wrote to Admiral Hopkins, restating Newport News' desire to negotiate in good faith but indicating that the Navy had shown no desire to negotiate. Dart also stated that he felt Admiral Rickover to be the major stumbling block in negotiations.

VI. THE RULE DECISION

A. RULES APPOINTMENT

On July 13, 1976, the Shipyard instituted a motion before the Federal District Court. In an effort to enforce the Agreement of 29 August 1975, Newport News asked that the court suspend the shipyard's obligation to continue work on DLGN-41. Also on that day, a meeting was held in DEPSECDEF Clements' office at which Gordon Rule was present. The Court later found as fact, based on argument before the Court again that same day, that at that time Gordon Rule was appointed by the DEPSECDEF as Chief Negotiator for the CLGN-41 dispute, with authority to bind the United States to a compromise agreement. It was also the Court's opinion that this was a direct response to Newport News' filing on 13 July 1976.

Deputy Secretary Clements instructed Rule that he wanted to see four items negotiated in any CLGN-41 compromise agreement:

(a) A new escalation clause

(b) A new "changes in the law clause"

(c) A new ceiling price

(d) A new delivery schedule.

Clements instructed that he was to be informed daily, in detail, of the progress to compromise.[1]

Newport News interpreted Rule's appointment as the Navy's intention to negotiate in good faith and on 16 July 1976 requested the court stay action on its 13 July motion.

B. RULE'S ASSESSMENT: WHAT WAS NEEDED

In a memorandum to the Chief of Naval Material on 1 September, Gordon Rule gave a detailed description of his side of the issue. He stated that he had had no involvement with the CLGN-41 issue prior to being assigned negotiator, but, after preparing himself by reading all records and correspondence, that he could not help but conclude that "this record is almost beyond belief in vindictiveness, arrogance, harassment and bias on the part of certain Navy representatives."[2]

Mr. Rule felt that, "the Navy and Newport News were so dug into their respective positions that there literally, in my (Rule's) opinion, was no way they could be reconciled at this point in time except through infusion of some new faces to carry out the Court order." From the outset of negotiations, Rule felt that a rapid settlement was necessary and that negotiations could not deal only with those eight items in the contract modification P00018. The eight items referred to are shown in Exhibit 5. A realistic delivery date, and a realistic escalation schedule reflecting that date, were set as his key objectives.[4]

C. RULE'S ASSESSMENT OF THE AGREEMENT

The resultant agreement could be characterized by the following elements, according to Mr. Rule:

1. The cost envelope in Modification P00018, i.e., target cost, target price, ceiling price, and sharing matrix were unchanged.

2. The new delivery date set for the CGN-41 was August 1980.
3. The escalation clause was the same as that to be included in the new SSN711 contract and was effective through August 1980.
4. The escalation clause did not include a Newport News request for escalation payments on base costs over ceiling.
5. The agreement rejected a Newport News request for 105% progress payments for the first 50% of completion rather than the normal 100%.
6. There was agreement to 100% compensation for indirect costs.
7. Newport News agreed to waive all claims for delay and disruption costs in the CGN-41 delivery schedule resulting from or incident to any or all events, including Government actions or inactions occurring before the agreement date.
8. The Navy agreed to pay compensation for the cost growth experienced by Newport News for fringe benefits, energy costs, and changes in the law. The target price and ceiling price for this growth were to be computed on actual expenditures rather than on fixed expenditure tables, then currently in the contract.
9. Milestones reflective of the new delivery date would then be necessary.

10. A revision of schedule A (GFM) would also be required to synchronize with the new dates.

11. The agreement did not apply to any other contract changes.

12. The agreement required the Court's approval.

In giving his reason for modifying the CGN-41 contract, Mr. Rule stated the several factors that he saw in the case, which were of great litigative risk to a Court trial settlement on the case merits. They are as follows:

1. It could be shown by a trial that there were improper negotiations of the basic CGN contract by certain representatives of the Navy who were without authority to negotiate.

2. The terms of the CGN and other incentive contracts negotiated by unauthorized personnel would be shown in court to be unfair and improper.

3. Certain persons called as witnesses under oath would be so revealing of a conscious pattern of prejudice and petty vindictiveness toward the contractor that the court would not permit those types of actions and treatment to go unpunished.

4. Threats of retaliation against the contractor, such as no more business, etc., which threats would have serious economic effects on the contractor, have been made and would surely emulate against the Government.

5. There had been a failure to comply with Navy procurement directives in that Mod P00018 had not been

submitted to the Chief of Naval Material for approval. Had it been submitted, it would not have been approved due to an unfair shareline of 95/5 for the first 15% above and below target cost and 90/10 thereafter, whereas, on the original three ships, the shareline was 80/20.

Rule concluded that he had complied with the Court's order and that his settlement was in the best interest of the United States. He felt that the Navy and the shipbuilders should realize that Admiral Rickover must be kept out of Naval contracting and that the shipbuilders must not agree to unfair contracts.

VII. TEACHING NOTE

A. CASE FOCUS

In the short run, the CGN case deals with the development of policy in the Department of Defense, composed of players from a number or organizations. In particular it involves the deep set values of Admiral Rickover, Deputy Secretary of Defense Clements, and Mr. Gordon Rule.

In the long run, the case deals with Navy procurement practice, contracting procedures, and claims settlement. Here too, it is difficult to focus on one strategy. Selling of a ship is a collective effort. In particular, it covers fair contracting practices and application of limited resources to a complex and unstable environment.

B. CASE SYNOPSIS

NNSDCO and the Navy had a contract for the completion of three CGN's, with an option clause for two more. Delays developed in the construction of the original three, which delayed the execution of the option.

During this period, NNSDCO was attempting to expand and had taken on several commercial contracts requiring labor which they could not provide. The Navy work delay and problems required even more labor, which was unavailable. The only course remaining was late delivery, and this resulted in increased costs which were amplified by extreme inflation.

NNSDCO held that the option for the two additional ships was not valid and insisted upon a new delivery date and extension of the escalation clause. The Navy stood fast and, when NNSDCO ordered work stopped on the CGN-41, the Navy took the shipyard to court. Secretary Clements and Gordon Rule joined together and questioned Admiral Rickover's fairness in dealing with NNSDCO and achieved a negotiated settlement which was upheld by the court. Admiral Rickover insisted throughout the proceedings that any negotiation of the Navy's right to the original dates without compensation by the shipyard violated the Congress's sole right to grant relief. The Court chastised the Navy for its failure to negotiate in good faith and ruled only of the validity of the Rule settlement and not on the validity of the original option.

C. CASE DISCUSSION

There are three major milestones in the CGN-41 case at which decisions must be made by the student. They are: 1) validity of the option; 2) going to court; and 3) the settlement. At each of these milestones, the student should make an assessment as to whether the decision made by the Navy was the proper one given the information provided in the case.

1. Validity of Option

The Navy executed the option to construct the CGN-41 on 31 January 1975 through contract modification P00024. As

soon as the Navy exercised its option, NNSDCO brought forth several points which questioned the validity of the option. As presented in the text, NNSDCO felt the option was invalid, while the Navy felt that exercising the option was completely legal. Each of the points under question will be discussed here, giving each party's opinion.

a. Invalidity of Option Caused by Specification Changes

NNSDCO stated that the CGN-41 was not a follow ship to the CGN-38 class because not all changes made to the previous ships of the class had been incorporated into the CGN-41. The Navy's position was that, even though not all of the changes had been incorporated, these changes would not cause any significant differences in the ship and therefore, the CGN-41 was a follow ship. (Note: In the authors' opinion, NNSDCO's argument is not a valid one because changes are a fact of life in shipbuilding and follow ships do not necessarily have the exact same configuration as the lead ship.)

b. Invalidity of Option Caused by Commercial Impracticability

NNSDCO contends that it would suffer critical losses if required to build the CGN-41, but never revealed the actual figures showing this fact. Navy analysis showed that NNSDCO could make a profit under the provisions of the contract. Furthermore, the escalation clause covered increases in labor and material.

c. Invalidity of Option Caused by Mutual Mistake of Fact

NNSDCO alleged that both parties were mutually mistaken in assuming that the accepted maximum price would be sufficient, given the economic conditions. The Navy position was that the escalation clause would absorb increasing labor and material costs.

d. Invalidity of Option Caused by Unilateral Mistake as Precluding Option Exercise

NNSDCO's position was that the option was a unilateral offer until accepted by the other party. The option was included as part of the original contract, which was accepted by NNSDCO.

e. Invalidity of Option Caused by Unconscionability

NNSDCO contended that ceiling prices were ruinously low because of economic conditions. Once again, the escalation clause relieves this issue.

f. Illegality of Option Provision Because it is in Violation of ASPR

NNSDCO's position is based upon the ASPR regulation that requires prices to be fair and stipulating that no undue risks were to exist for either party. The Navy's position was that the price was fair and that the escalation clause reduced the risk on the contractor.

g. Illegality Because of Lacking Negotiating Authority

NNSDCO stated that there was neither statutory negotiation authority nor supporting D&P. The Navy's position was based on the fact that the original contract covered these items.

h. Invalidity Due to Insufficient Consideration

NNSDCO stated that there was no adequate new legal consideration to support modification extending option exercise dates. The Navy contended that this was not necessary, because NNSDCO had been given funds to cover extension.

i. NNSDCO contended that maximum ship prices were too low because of economic conditions. Once again, the Navy rebutted that the escalation clause covered increasing costs of labor and material.

j. NNSDCO stated that, because not all changes had been incorporated, the result was one of undefinitized, unfixed, and unknown prices. It is common practice, whenever a change is proposed on a ship design, to negotiate the cost of that change. This case is no different from any other shipbuilding contract.

k. NNSDCO predicted doom for the contract because of inadequate pricing due to the economic conditions. Once again, it was contended that the escalation clause protected the contractors against rising costs in labor and material.

It is the opinion of the authors that this attempt by NNSDCO to have the option ruled invalid was an attempt to divert from the real issue. It is the authors' opinion that the option was legal and valid and that NNSDCO did not want to build the ship because of a lack of capability at that time due to other commitments, namely commercial business. However, the authors also note that, had the option not been executed (a very likely event), and had

NNSDCo not had the commercial contracts, the shipyard would have had serious losses due to a lack of work.

2. Going to Court

On 27 August 1975, when NNSDCO discontinued work on the CGN-41, the Navy took NNSDCO to court. The decision at that point was whether to seek a decision on the validity of the option or to negotiate. There appears to be two sides to this issue.

a. In the opinion of NAVSEA and Admiral Rickover, there was no legal basis to modification of the original contract. The CGN contract did not stand alone; rewriting the option would have opened the door to many other contracts. Neither party had changed from its earlier final positions.

b. Deputy Secretary Clements and Assistant Secretary of the Navy Bowers sought to restore business relations between the two parties. The relationship between the two had deteriorated to the point that there occurred alleged threats of not giving and not accepting future Navy contracts. It was apparent that NNSDCO would take a loss on the production of the CGN-41. Private industries, such as oil companies, were granting contract changes without compensation, in recognition of the escalation and scarcity of material during this period.

It is the conclusion of the authors that the Navy could not legally yield and, therefore, should have sought a ruling on the validity of the option. In the interest of the country, P.L. 85-804 could have been applied and would have

been the proper remedy. Had the Court ruled against the option, the negotiation of the settlement might not have been different from the final outcome.

3. The Settlement

It must be pointed out that the validity of the option was never resolved. The validity of the settlement made by Mr. Gordon Rule was ruled on and upheld. Here, the question is whether or not the settlement should be contested in an Appellate Court.

a. Gordon Rule had a warrant and he made an agreement under that warrant which was legally binding on the United States. NNSDCO agreed to it in good faith. This agreement was approved by the Deputy Secretary of Defense. It was fair in that claims were dropped in return for changes in delivery dates and escalation clauses.

b. Gordon Rule signed a document and delivered it in direct disobedience of his superiors. The Navy was illegally committed to a course of action which was itself illegal. The Navy did not agree to the validity of the claims and could not have received any consideration for the increased costs. Only the Congress can renegotiate a contract which does not exchange equal benefit to the Government. This case sets a bad precedent for other contracts.

The settlement reached by Mr. Gordon Rule with Newport News Shipbuilding and Drydock Company was appealed by the Government to the Fourth Circuit Court of Appeals in Richmond, Virginia. The settlement reached by Mr. Rule was

upheld in the Federal District Court of Eastern Virginia. In an article in the Wall Street Journal, dated March 2, 1978, it was reported that the Appeals Court had reversed the District Court's ruling because the parties negotiators did not settle the case orally and the Attorney General, whose approval was essential, rejected the terms that were ultimately reduced to writing.

The reversal sends the case back to Federal District Court for further proceedings. The Appeals Court declared that the lower courts finding that the Navy did not negotiate in good faith was inappropriate. In the Appeal Court's opinion the critical question was whether the oral agreement was binding, and they ruled that it was not binding.

D. LONG TERM PROBLEMS AND RECOMMENDATIONS

1. Discussion

In addition to the immediate problems posed by the CGN-41 case, there are several long range issues which the student should discover. This section is presented to offer the instructor additional information in guiding the discussion on these issues.

Long term issues, which were illuminated by the CGN-41 case, consist of fair pricing and scheduling, stability in the shipbuilding industry, maintenance of the industrial base, escalation provisions, and the type of contract to be used in ship procurement.

2. Issues Pertinent to Case

a. Fair Pricing and Scheduling

One of the NNSDCO's major points throughout the CGN-41 dispute was that the maximum price for the ship was ruinously low. To further emphasize this point, the Shipbuilders' Council of America, in a 1974 report, stated that the Navy foregoes realism in forward pricing in order to sell its programs.[1] In testimony before a subcommittee for the House of Representatives' Committee on Appropriations in 1977, NNSDCO officials stated that there have been overly optimistic estimates of ships' costs provided by the Navy in the past. This Committee, during this same period, seriously questioned the Navy on the manner in which they estimate the cost of ships. The Navy was accused of requesting funding from Congress for the construction of complex ships before they are designed. When requesting funding, the cost estimates are based on a class F (ball park) estimate or a class D (feasibility estimates due to insufficient design, production, or cost information) estimate. In 1969, the Navy did a study to determine the accuracy of class D and F estimates and found that they were about 20 percent below actual costs. The Navy has requested funds for the FFG-7 class, Trident submarine, and DDG-47 destroyer (among others) using either a class D or F estimate.[2] Both Congress and the President have directed the Navy to provide class C estimates in the future. A class C estimate is budget quality. Whether or not this will extend the procurement period significantly is unknown.

Shipbuilders have stated before Congressional committees that the Navy imposes unrealistic delivery dates on contractors and that this is a major cause of cost growth. The Navy rebuts this with the fact that, at contract award, the delivery dates are mutually agreed upon by both parties. When Mr. Clements was Deputy Secretary of Defense, in a letter to the Shipbuilder's Council, he warned that, before entering into a contract, contractors should carefully review the proposed delivery schedule and weigh this against their projected ability to perform.[3]

b. Stability

Shipbuilders have repeatedly stated before Congress that the lack of a national long-range shipbuilding program has hampered their efforts. Because of the year to year uncertainty in the volume of work, there is really very little incentive for capital investment to upgrade facilities. Additionally, the lack of stability has an adverse effect on labor. Turnover rates for the shipbuilding industry have averaged approximately 40 percent and in some trades, it has reached as high as 70 percent.[4]

The uncertainty perceived by shipbuilders is a result of many factors: changing needs of the Navy due to changing threats and changing leadership; reassessment by senior DoD officials and the President; and Congressional influence. These factors were vividly described in the case of the AEGIS debate. In the case of the CGN-41, it is quite possible that NNSDCO concluded that the probabilities that Congress would approve the CGN-41 and that the Navy would

exercise the option were very low. Following this hypothesis, it was good business for NNSDCO to pursue commercial contracts which would stabilize their workload during a period of low activity with respect to Navy business. When the Navy exercised its option, NNSDCO was left in a very untenable position since they did not have the capability to perform both the commercial and Navy work under the terms laid out in the contracts. If you follow this premise to this point, it is no wonder that NNSDCO attempted vigorously to avoid the CGN-41 (or to at least have the delivery date extended), so that they would not incur any penalties on commercial work.

Another area where the contractor is affected by the unstable nature of Navy shipbuilding is in work force planning and utilization. Mr. Diesel, in testimony before Congress in 1974, stated that trade skills in quantity are extremely costly to the shipbuilder. When the backlog is down, the skilled forces must be reduced. When the backlog builds up, long training programs are required to increase the skills of new replacements to an acceptable level. The impact is also on the worker himself. Due to the uncertainty in constant employment, many workers leave to find more permanent employment. Another factor is the wage differential between shipbuilders and other construction industries which induced skilled workers to leave shipbuilding. The Navy contends that the shipyard problems are due to a drop in productivity, but this can be attributed to the high

turnover and fluctuation in the number of workers, which is again due to changing shipyard workload.

c. Industrial Base Maintenance

It has been well documented how the number of shipyards engaged in Navy shipbuilding has dwindled in the last 10 years, but another factor, just as important, is that the number of suppliers to the shipyards has also decreased. Part of the cause of this deterioration of an overall industrial base is the constant turmoil of Navy procurement. The necessary industrial base will be determined by the size of the fleet required by the Navy and the number of shipbuilders who actively engage in shipbuilding and still make a profit with consistency.

This case deals with NNSDCO, which presently is the only shipyard capable of building nuclear surface ships. Because of the small number of nuclear surface ships being requested at this time, one shipyard is sufficient, but if the decision were made to increase our surface nuclear fleet, the capability would not be there. Realistically, because of the high cost of these vessels, it is doubtful that any significant increase will occur. However, another argument is that (because of the specialized skills required) it would be difficult to sustain very many yards at a level to properly utilize the manpower.

Another aspect of this problem is that the commercial shipbuilding industry does not provide a sufficient workload to alleviate the fluctuations in Navy shipbuilding.

If the commercial shipbuilding industry in the United States were bigger, changes in Navy shipbuilding requirements would not have such a large impact. The manpower levels could be more constant with a more constant workload. The aerospace industry in the United States is a good example of an industry which can better adapt to fluctuations in military procurement because they have a much larger commercial base. Because of the dollar value of the military aircraft purchases, attempts have been made to apply "successful" management techniques from this industry to the shipbuilding, ignoring the fundamental difference.

The more immediate problem is the loss of the suppliers. By having fewer qualified suppliers, the competition is reduced and prices go up. More competition at this level could and should be generated to ensure a quality product at a reasonable price. Industry has contended that, because of Navy control, many suppliers refuse to do business with the shipyards.

d. Escalation Provisions

Shipbuilders have alleged that escalation clauses have been inadequate in the past. Prior to 1975, escalation was based on the contract delivery date and the ceiling price. To determine the amount paid, indices were developed from the Bureau of Labor statistics. Therefore, if the contractor was unable to complete the work by the delivery date specified, he would assume an increased portion of the risk for any increased costs.

Admiral Rickover, in testimony before Congress in 1974, stated that shipbuilders generally do not receive escalation payments if they exceed the target cost or delay delivery when these increased costs or delays are not the fault of the Government.

J. P. Diesel stated, during these same hearings, that the shipbuilders are exposed to all the risks of inflation if the target cost is exceeded. In comparing the private and public sector, he stated that in the private sector, either the price of an item is determined at the time of delivery, or the seller is allowed to include his own best estimate of the effect of inflation on his selling price. Neither of these options is available when dealing with the Government; instead, the target and ceiling prices are set years in advance of delivery.

Beginning with contracts awarded in 1975, the Navy liberalized the escalation clause to provide for more equitable distribution of risk. The new clause allows for payment on the basis of actual expenditure phasing, and allowable costs incurred not to exceed ceiling price. Importantly, unlike previous clauses, payment is to continue to actual delivery date.

It must be pointed out that the old clause required the determination of cause of the delay. This demanded settlement from the inception of the contract. Secondly, the risk in forecasting feasible dates far in advance might not justify such strong incentives.

e. Contract Types

To characterize most previous Navy shipbuilding contracts, it can be said that they were fixed price incentive fee (FPIF) contracts and covered systems which were under concurrent development and construction. The Navy has come under considerable attack from shipbuilders for employing this procedure. The shipbuilders contend that, under FPIF contract, they assume too much of the risk, and contracts must be restructured so as to equitably distribute the risk.

The contractors have proposed cost type contracts for the lead ship of a class, and a longer period of time between the lead and follow ship construction. By incorporating these innovations, claims should be reduced. In testimony before the Seapower Subcommittee for the Committee on Armed Services for the House of Representatives in 1974, J. P. Diesel, J. T. Gilbride, E. Hartzman, and F. W. O'Green recommended that Congress require the Navy to contract for new ships on a cost type basis until inflation is brought under control and existing procurement problems are solved.[5] At these same hearings, the then Secretary of the Navy Middendorf stated that many of the present claims problems appear to stem largely from improper application of fixed price contracts. Many Navy personnel involved in the acquisition process have also proposed the use of cost type contracts on lead ships. In a memorandum to Admiral Michalais on 7 May 1976, Admiral Evans proposed several changes to the ship

acquisition process. Among the proposals were the use of cost type contracts for lead ships, the use of more flexible delivery dates, longer intervals between construction of lead and follow ships, higher target to ceiling cost spreads, and, finally, when using a fixed price contract, the inclusion of a clause which recognizes a single contingency, such as an upcoming union agreement.[6]

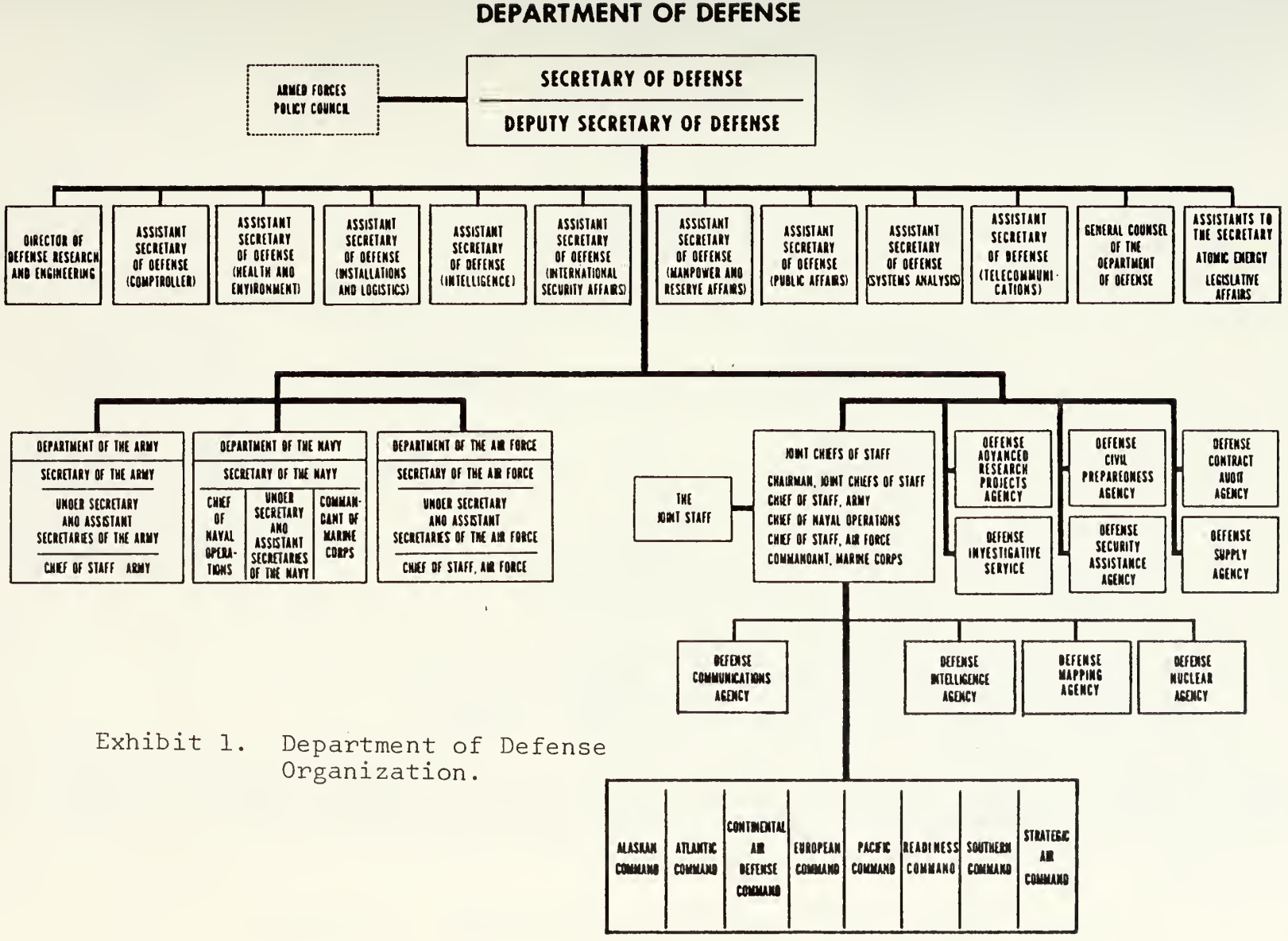
The consensus for change to cost type contracts was not unanimous. One of the major dissenters was Admiral Rickover. He felt that the Navy should remain with fixed price incentive fee contracts because it gives financial incentive to the contractors. He further recommended that if the problems experienced with the contractors cannot be resolved, the Government should acquire all shipyards and contract with private companies for operation. Admiral Rickover has cited, as precedence for this action, the aerospace industry. Most of the facilities used to produce aircraft for the military are owned by the Government and industries contract for their use.[7]

Many of the recommendations made by Admiral Evans have been incorporated into the contract for the FFG-7 class ship procurement. At this time, it is difficult to determine the success of the contract, but it is being promoted as a model for the future. However, it is anticipated that claims problems will be reduced because of the cost type contract for the lead ship and because a longer period of time has been allowed between the lead and follow ships.

E. OTHER CONSIDERATIONS

The enclosed appendices have been included to provide amplifying information for readers who are unfamiliar with the shipbuilding industry and procurement procedures.

Appendix D has been included because many of the issues raised in the CGN-41 case are also present in claims cases and information is provided to extend any discussion of the case into the general realm of claims.


DEPARTMENT OF DEFENSE
ARMED FORCES POLICY COUNCIL
SECRETARY OF DEFENSE
DEPUTY SECRETARY OF DEFENSE
DIRECTOR OF DEFENSE RESEARCH AND ENGINEERING
ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)
ASSISTANT SECRETARY OF DEFENSE (HEALTH AND ENVIRONMENT)
ASSISTANT SECRETARY OF DEFENSE (INSTALLATIONS AND LOGISTICS)
ASSISTANT SECRETARY OF DEFENSE (INTELLIGENCE)
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ASSISTANT SECRETARY OF DEFENSE (SYSTEMS ANALYSIS)
ASSISTANT SECRETARY OF DEFENSE (TELECOMMUNICATIONS)
GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE
ASSISTANTS TO THE SECRETARY
ATOMIC ENERGY
LEGISLATIVE AFFAIRS
DEPARTMENT OF THE ARMY
SECRETARY OF THE ARMY
UNDER SECRETARY AND ASSISTANT SECRETARIES OF THE ARMY
CHIEF OF STAFF ARMY
DEPARTMENT OF THE NAVY
SECRETARY OF THE NAVY
CHIEF OF NAVAL OPERATIONS
UNDER SECRETARY AND ASSISTANT SECRETARIES OF THE NAVY
COMMANDANT OF MARINE CORPS
DEPARTMENT OF THE AIR FORCE
SECRETARY OF THE AIR FORCE
UNDER SECRETARY AND ASSISTANT SECRETARIES OF THE AIR FORCE
CHIEF OF STAFF, AIR FORCE
THE JOINT STAFF
JOINT CHIEFS OF STAFF
CHAIRMAN, JOINT CHIEFS OF STAFF
CHIEF OF STAFF, ARMY
CHIEF OF NAVAL OPERATIONS
CHIEF OF STAFF, AIR FORCE
COMMANDANT, MARINE CORPS
DEFENSE ADVANCED RESEARCH PROJECTS AGENCY
DEFENSE INVESTIGATIVE SERVICE
DEFENSE CIVIL PREPAREDNESS AGENCY
DEFENSE SECURITY ASSISTANCE AGENCY
DEFENSE CONTRACT AUDIT AGENCY
DEFENSE SUPPLY AGENCY
DEFENSE COMMUNICATIONS AGENCY
DEFENSE INTELLIGENCE AGENCY
DEFENSE MAPPING AGENCY
DEFENSE NUCLEAR AGENCY
ALASKAN COMMAND
ATLANTIC COMMAND
CONTINENTAL AIR DEFENSE COMMAND
EUROPEAN COMMAND
PACIFIC COMMAND
READINESS COMMAND
SOUTHERN COMMAND
STRATEGIC AIR COMMAND

Exhibit 1. Department of Defense Organization.

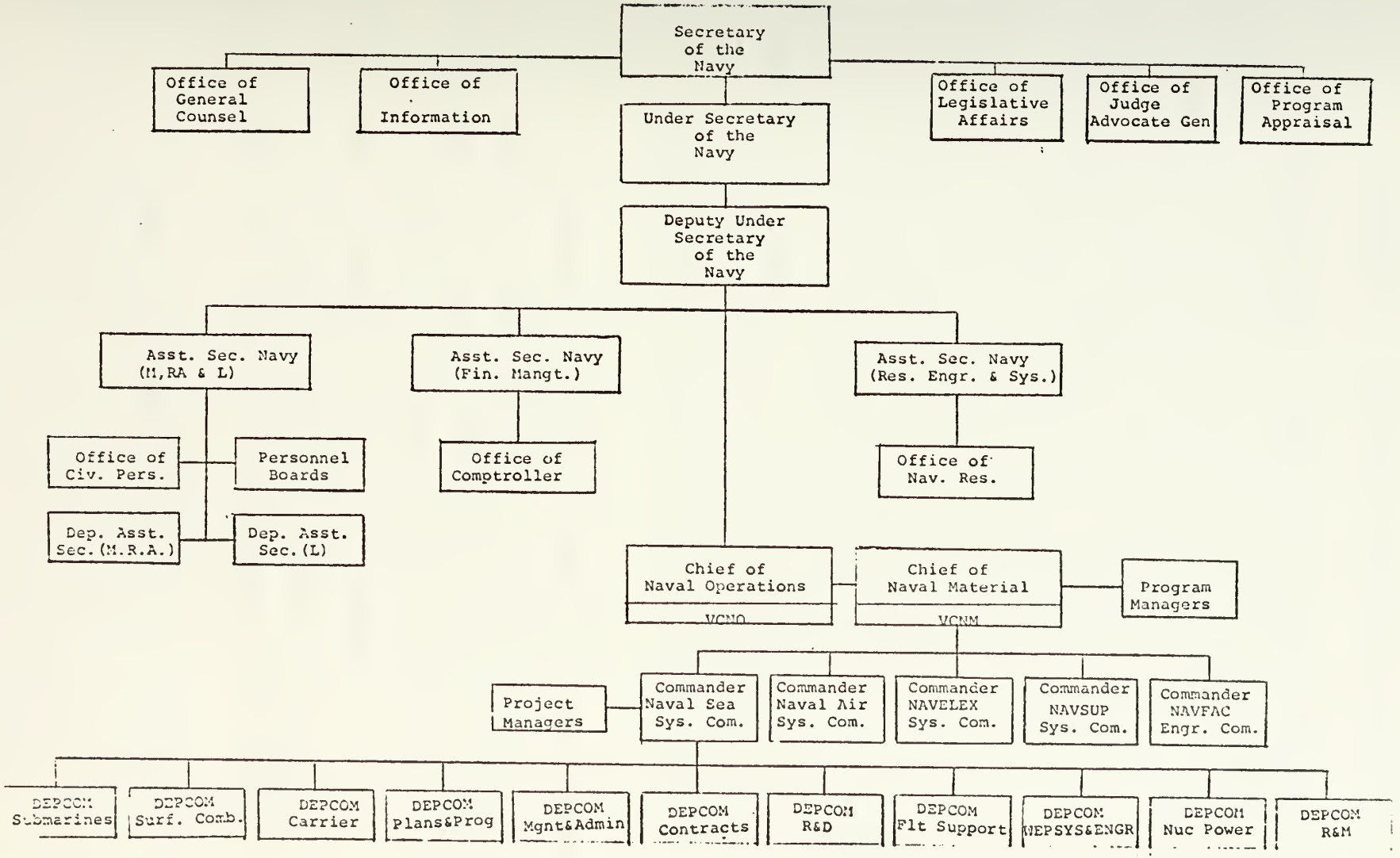

Exhibit 2. Department of the Navy Organization

Exhibit 3. Contract Modification P00018

The parties agree to negotiate in good faith to reach an agreement as rapidly as possible on the provisions of this contract which requires modification in order to express the greement of the parties as to new option provisions for DLGN-41 and DLGN-42. Therefore, such contract modification will:

i) establish a target cost, a target price, a ceiling price, and a share ratio within the profit-cost envelope set for the below for each option so exercised separate from that for the other ships under this contract, and revise Article 7, entitled "Limitation of Contractor's Liability for Correction of Defects," to provide a limitation on the contractor's liability for correction of defects for each vessel to two percent (2%) of the initial target price for that vessel;

ii) pursuant to Article 5 hereof, titled, "Incentive Price Revisions (Firm Target)," provide for a total final negotiated cost separate from DLGN-38, 39 and 40 combined;

iii) establish escalation tables separate and different from those for DLGN-38, 39 and 40 combined;

iv) as necessary, modify the payment provision to provide payment for DLGN-41 and 42 separate from DLGN-38, 39 and 40;

v) revise the project milestones in Article 17 for DLGN-41 and 42;

Exhibit 3. (continued)

vi) establish a fixed fee and other terms and conditions on account of the work which may be required by the Option Conditions described below which will be effective until the corresponding option is exercised, or the work, which may have been continued pursuant to the direction of the contracting officer stops;

vii) contain a provision for computing equitable adjustment because of changes in the Longshoremen and Harbor Workers' Act, the Federal Insurance Compensation Act, State Workmen's Compensation Act, Unemployment, Disability Compensation and Public Liability Acts occurring since June of 1970; and

viii) revise schedule "A" to provide for DLGN-41 and 42 equipment delivery schedules to conform with those listed for DLGN-39.

Exhibit 4. Navy Maximum Position

Target Profit = Target Price - Target Cost

	Target Cost	Target Price	Ceiling Price
DLGN-41	$76,050,000	$85,741,000	$100,951,000
DLGN-42	$74,650,000	$84,162,500	$ 99,095,500

Incentive Formula

Case	When the total negotiable cost, x is:	Profit (+) or Loss (-) will be equal to:
a	x < 85% Target Cost	Target profit + 5% (Target cost - 85% Target cost) + 10% (85% Target cost - Negotiable Cost)
b	100% > x > 85% Target Cost	Target profit + 5% Target cost - Negotiable cost
c	x = Target Cost	Target profit
d	100% < x < 115% Target Cost	Target profit - 5% Negotiable cost - Target cost)
e	x > 115% Target Cost	Target profit - 5% (115%-100% Target cost) -10% (Negotiable cost - 115% Target cost)

Exhibit 5. Item That Must Be Negotiated Under the DLGN 41 and DLGN 42 Contract Options

1. Maximum Price and Ceiling - The maximum price is negotiable downward only.

2. Contract Closeout Accounting Procedures - This is a necessary administrative item as a result of the separate pricing structure of DLGN-41 and 42 and is not a matter of disagreement.

3. Escalation Tables Separate and Different from DLGN 38-40 - Separate pre-negotiated and fixed tables are required to effect the separate pricing structure of DLGN-41 and 42 and to replace escalation tables established in the original contract for different contract delivery dates. Newport News is entitled to negotiate an equitable escalation distribution based on the material and labor expenditure schedules. To date Newport News has not been willing to discuss the fixed escalation tables, required by the contract, but has instead proposed that escalation be paid based on whatever expenditure schedule Newport News incurs in contract performance, regardless of ceiling price or contract delivery date. Under the contract any agreement must have a pre-negotiated expenditure schedule. Any agreed to schedule would have to be consistent with the contract delivery dates. The negotiable range represents about three million dollars per ship in eventual escalation payments.

4. Payment Provisions - Newport News is entitled to negotiate a new payment provision for the DLGN-41 and DLGN 42. Newport News has proposed that payments based on progress not to exceed 105% of incurred cost (up to ceiling) be made. This proposal is consistent with the CVAN-68, 69 and CVN-70 contract and is considered equitable. The proposal for DLGN-41 and DLGN-42 differs from that agreed to in the DLGN-38 contract only in that maximum payments of 105% in lieu of 100% of cost over the first half of the contract are proposed.

5. Revise the Project Milestone - Negotiation of this item is not significant to settlement of price within the specified delivery dates.

6. Interim Fee for Long Lead Material Procurement Effort - This item provides for interim payment of fee for long lead effort until exercise of the option incorporates the interim fee into the total contract price and fee structure. Because the DLGN-41 option has been exercised, this item does not have to be negotiated for DLGN-41. In their unacceptable repricing proposal Newport News has proposed a 7½ percent interim profit on the long lead effort for DLGN-42. Since the long lead effort is primarily material procurement and

is, in total, on a cost-reimbursable basis, 5 percent is the maximum interim profit that should be accepted. 5 percent is consistent with the CVN-70 long lead effort agreement.

7. Changes to Workmen's Benefits - This item covers increase in cost due to changes in federal and state laws as social security and workmen's compensation occurring since June, 1970. Reimbursement of Newport News for these added costs will result in estimated payments of about 7.5 million dollars per ship. It is a Navy obligation under the Contract to make such payments outside the pricing envelope. The amount of the payments will be fixed by the actual changes in the federal and state laws. The only negotiable item is the structure of the clause that does this.

8. Schedule for Government Furnished Equipment Delivery - This is an administrative matter. The Navy can support construction schedules.

APPENDIX A. NOTE ON SHIPBUILDING INDUSTRY

A. WORLD MARKET

The world's principal shipbuilding industries are found in Japan, Europe, and the United States. Japan is the single largest shipbuilding nation in the world, producing approximately 50% of all the ships measured in dead weight tonnage. The European countries, primarily Sweden, Great Britain and West Germany, account for nearly 50% of the dead weight tonnage, also. All of this indicates that the United States is not an important factor in the world's shipbuilding market.

Although it would be difficult to compare prices and costs between the various shipbuilding nations, some comparisons can be made to show why the world market is structured the way it is. The most significant relationship is the difference between the controllable-uncontrollable cost breakdown between the United States and Japan. In the United States the uncontrollable costs constitute approximately 50% of the total costs while in Japan these costs are only 30% of the total costs. United States shipbuilders have little control over their costs, and because of their low volume, they cannot exert any real leverage on their suppliers. Therefore, for a U.S. shipbuilder to reduce costs by 2%, he must reduce shipyard costs by 4 to 5%.[1]

Another important factor is the relationship between a country's government and its shipbuilders. For instance, in Japan, the national policy is intimately linked to its shipbuilders and the government utilizes control and inter-

vention to maintain a strong shipbuilding industry. Shipbuilders have utilized Government sponsored programs in which shipyards are guaranteed contracts for up to six years, and this strengthens the industry. With this type of approach, the shipbuilders can do extensive advance planning and can rely on heavy capital investment to improve their efficiency. Similar practices are used in European countries. This huge capital investment into more advanced techniques has not been widely seen in the United States because of the manner in which shipbuilding orders are placed without the guarantee of a long term backlog of orders. The United States shipbuilding industry represents only 0.3% of this country's GNP, ranking 40th along with the soft drink industry, cigarette industry and cosmetics.[2]

To illustrate the differences in productivity of the different countries, a flow rate index has been developed. The flow rate index is the ratio of tons delivered during the year, divided by the tons under construction at the start of the year, where a value of 100 means equal volumes. Japan has consistently had flow rate indexes above 150 and Europe has had values near 100, while the flow rate index for the United States has been near 50.

B. MERCHANT MARINE ACT OF 1970

In an effort to build up the U.S. Merchant Marine so that it could be a competitive force, Congress passed the Merchant Marine Act of 1970. This act allowed for the use of federal government funds to allow for construction-differential sub-

sidies, operating differential subsidies, an ongoing research and development program, and to provision for training. One of the primary purposes of this act was to increase commercial shipbuilding orders to domestic shipyards on a long term basis. This encourages capital investment, which improves the efficiency of the shipbuilders.

Construction subsidies are based on the difference between United States and foreign shipbuilding costs. These subsidies are paid to U.S. shipbuilders so that ships can be constructed at the same cost as that charged by a foreign shipbuilder. For example, if the cost to produce a ship is $100 million in a domestic shipyard and the cost in a foreign shipyard is $70 million, the U.S. government would pay the difference of $30 million to the shipbuilder. To pay the remaining $70 million, the buyer must contribute 25% of this and the U.S. government will guarantee a loan for the remaining 75%.

Operating subsidies are also based upon the difference between United States and foreign vessel operating costs and are paid to promote the maintenance of a U.S.-flag merchant fleet capable of providing essential shipping services.

After the passage of the Merchant Marine Act of 1970, American shipbuilders have made $371 million in capital investments in the first four years and have investments of another $343 million planned. The leaders in capital investment have been Newport News Shipbuilding and Drydock Company, Todd Shipyards, and Litton's Ingalls Shipyard.

American shipbuilders, who engage in U.S. Navy shipbuilding, do so in a way that has been unique within Defense Depart-

ment acquisition contracting. Until recently they were the only contractors who were able to recover costs due to rising prices and labor costs under the escalation clause included in all contracts.

C. U. S. SHIPBUILDERS

There are 188 private shipyards and shipwork contractors with Navy master ship repair contracts; 117 of these are on the Navy's bidders'list for new construction and conversion programs. The dollar value of the backlog in these shipyards as of January 1977 was $9.9 billion. This backlog is composed of 162 ships of which 91 are Navy and 71 are commercial. Of the 117 shipyards on the Navy's bidders' list, only 11 have current and previous major Navy new ship construction experience. There are currently 96 ships under contract, and of these, 65 are in three shipyards: Newport News, Electric Boat (General Dynamics), and Litton.[3]

Between 1968 and 1977, average construction of new ships was 13 per year and, under present plans, the Navy is striving for 31 ships per year. Historically, U.S. shipbuilders have had a difficult time in acquiring, training, and keeping qualified personnel, with turnover rates averaging over 40% per year. The major contributions to this problem appear to be a lack of assurance of continuing work, unpleasant working conditions, and wage rate differentials within the construction industry.

The following outline briefly describes the capabilities of the major United States shipbuilders and indicates which

of these currently, or have in the past been, engaged in shipbuilding for the U.S. Navy:

1. Avondale Shipyard, Inc.

   a. Facilities:

      Two side launching ways, one of which is capable of building ships up to 600 feet long and 80 feet beam, weighing up to 5000 long tons. It is actually a five position assembly line. 75% of the labor is expended before the ship is launched. The other way is similar, but can build ships 1200 feet long and 130 foot beam, weighing 15,600 tons. Divided between three piers, there are 3565 feet of pier space for final outfitting and overhauls. Support equipment includes cranes, a derrick barge, and a floating dock.

   b. Avondale Shipbuilding is one of the most modern facilities in the United States- having made the shipbuilding process very similar to an assembly line process. Previous Navy shipbuilding consisted of ships of the DE 1052 class. Commercial ventures include LASH ships and oil rigs.

   c. Avondale is unique in another respect, in that it is a non-union yard. The local labor pool can provide 20% of the necessary skills, and the remainder must be trained on the job, with shipfitters the hardest to hire.

   d. Avondale Shipyards is owned by Bayou Shipyards, which is a subsidiary of the Ogden Corporation.[4]

2. Bath Iron Works Corporation

   a. Facilities

      There are 3 building ways. In each of these building ways, they have the capability of building ships up to 650 feet long with a beam of 80 feet, and in two of the ways, two ships can be built, side by side. There are two wharves totaling 930 feet and a 626 foot pier available for outfitting. There is also a partial drydock used for bow sonar dome installations. The more conventional shipbuilding methods are used by Bath.

   b. Bath is currently the lead shipyard in the FFG-7 class construction.

   c. The corporation experiences difficulty in obtaining skilled workers from the local labor pool, but utilize a training program. There is a continued loss of trained personnel to other industries, particularly to the construction industry. This problem is especially acute during the spring.[5]

3. Bethlehem Steel Corporation, Shipbuilding Division, Sparrows Point Yard

   a. Facilities

      There are 7 building ways, with the largest of these being 769 feet by 110 feet. There is also a building basin with a capacity for vessels up to 300,000 dead weight tons. There are 4

piers with a total length of 3970 feet, and two of these are available for outfitting.

b. Bethlehem Steel has removed itself from Navy shipbuilding and is currently working on large commercial tankers.

c. They have difficulty in getting and maintaining an adequate force and limit their commitments to that which can be accomplished with the available work force. Management feels that there is a 20 year gap at the craft level and considers this a major problem.[6]

4. General Dynamics Corporation, Quincy Shipbuilding Division

a. Facilities

At the Quincy facility, there are three building basins capable of building vessels up to 225,000 dead weight tons. The corporation has recently expanded their operation by acquiring the facility at Quonset Point.

b. General Dynamics is currently building (or has under contract) 18 attack submarines and 5 Trident missile submarines. In 1972, the company committed itself solely to the building of Navy submarines and is regarded as a leader in this area.

c. General Dynamics does not see the labor market as a constraint to expansion, but admits to difficulties in obtaining sufficient shipbuilders

with experience. There is a very active training program and government supported programs for veterans and minorities.[7]

5. Litton Industries

   a. Facilities

      Litton has two facilities: the East Bank, which is a conventional shipyard, and the West Bank, which uses a modular construction method. On the East Bank, there are 7 usable building ways with the largest capable of 18,000 long tons. There are 3700 feet of mooring space for outfitting. The West Bank is one of the most modern facilities in the United States. It consists of an assembly area with 5 bays and an integration zone. The launch pontoon is capable of holding a ship with an equivalent weight of 160,000 DWT. The ships constructed by the modular process are 80-90% outfitted prior to launch.

   b. Litton, in the past, has constructed nuclear submarines for the Navy and is now under contract for 5 LHA's and 30 destroyers. In addition, Litton is also executing contracts on several commercial ships.

   c. Litton feels that the labor market exists to meet demand, but also realizes that it is in competition with other construction industries for skilled craftsmen. Both facilities exercise

extensive training programs, incorporating classroom type training with on-the-job training.[8]

6. National Steel and Shipbuilding Company (NASSCO)

   a. Facilities

      The facilities include 4 building ways with a maximum capacity of 21,000 long tons. There is a total of 3800 feet of pier space for outfitting and repair.

   b. NASSCO primarily deals with commercial tanker construction, but has constructed Navy ships. Their largest Navy contract was for 17 LST's in the early 1970's. They have also built several auxiliary ships and are presently under contract to build two destroyer tenders.

   c. NASSCO has a good local labor pool to draw from, but it is not adequate to fill the necessary crafts when the yard approaches full employment. When they go outside the local area, there is stiff competition, particularly for pipefitters and shipfitters. Also, they lose qualified personnel to other construction industries due to lower pay in NASSCO yards.[9]

7. Newport News Shipbuilding and Drydock Company

   a. Facilities

      The facilities include 5 building ways, with the largest capable of handling a ship up to 50,000 long tons. There are also two building basins able to handle a ship up to 80,000 long tons.

It has recently expanded its facilities to include the capability of building ultra-large cargo carriers up to 250,000 DWT. It has also more than 7000 feet of pier space for outfitting and repair.

b. Newport News is very active in both commercial and Navy shipbuilding and repair. Newport News is the only shipyard in the United States which builds nuclear surface ships; it has built nuclear aircraft carriers and cruisers. It is also currently the leading shipyard in the construction of the attack submarine (SSN-688).

c. Newport News has one of the lowest turnover rates in the U.S. shipbuilding industry; it feels that sufficient labor exists to fulfill their needs; there is no constraint to expansion. However, there is considerable effort placed by other industries to hire away people who have been trained in nuclear engineering. One of these groups is the Norfolk Naval Shipyard. Newport News has an extensive apprenticeship program to train qualified personnel.[10]

8. Todd Shipyards Corporation

a. Facilities

Todd has divisions in Brooklyn, New York; New Orleans, Louisiana; Galveston, Texas; Houston, Texas; San Pedro, California; Alameda, California; and Seattle, Washington. The Seattle and San

Pedro Divisions are the only ones in ship construction, but the Galveston Division is expanding to include construction of very large cargo carriers.

The facilities at San Pedro Division consist of two building ways capable of handling ships up to 7000 long tons, two floating dry docks, and approximately 3000 feet of pier space.

The facilities at the Seattle Division consist of two building ways capable of handling ships up to 4500 long tons, three dry docks, and pier and wharf space which can berth 11 ships.

b. Currently, both the Seattle and San Pedro Divisions are actively engaged in commercial shipbuilding. However, Todd is under contract to the Navy to build seven ships of the FFG-7 class as the follow shipbuilder to Bath Iron Works.

c. The San Pedro Division has difficulty in obtaining qualified personnel in the outfitting trades, but sees no constraint on expansion because of the labor. They do not use an apprenticeship program but rather on-the-job training.
The Seattle Division has difficulty in obtaining enough qualified welders and boilermakers, but sees no real constraint on expansion due to labor. It has training programs to meet specific needs; it also employs an apprenticeship program in the more critical trades.[11]

APPENDIX B. NOTE ON NEWPORT NEWS

A. HISTORY

The Newport News Shipbuilding and Drydock Company was founded by the industrialist and railroad magnet, Collis P. Huntington, in 1886 in order to stimulate activities at the port terminus of the Chesapeake and Ohio railroad, which he controlled. The Shipyard remained family owned until it went on the New York Stock Exchange in 1940. In 1968 the Shipyard was purchased and now is wholly owned by Tenneco, a major company with extensive interests in chemicals, natural gas pipelines, oil, automotive parts, farm and construction equipment, packaging, and land use. When it was purchased, the yard had become one of the largest and best equipped in the world, as well as the largest in the United States.[1] In 1973, Tenneco, based in Houston, Texas, rated fifteenth in assets in the 1973 Fortune's "five hundred."[2]

The Newport News Shipyard is located on 470 acres along a two mile stretch of the James River in the lower peninsula of Virginia. The port is referred to as Hampton Roads. The northern bank community has a population of approximately 292,000. It is located directly across the river from the large Naval Shipyard at Portsmouth, Virginia and from the largest U.S. Naval concentration of ships, at Norfolk, Virgina. The community from which the Company received its name had originally received the name, Newport News, after good news was brought to the port by a Merchant Captain Newport in the pre-colonial period.[3] Today the Yard consists of six

graving docks, six sliding type building ways, and ten piers. It is manned by 26,000 employees, some of whom are fourth generation employees. The Shipyard does not build modular hulls, as are built by Litton and General Dynamics. Rather, each ship is custom built.

Newport News has built over 600 ships of all types. In World War I, Newport News built over twenty percent of the U.S. Fleet. In 1934, the Shipyard delivered the first ship built, from the keel up, as an Aircraft Carrier, the USS Ranger. Since that time, Newport News has designed and constructed all but one of our aircraft carriers. In 1960, Newport News delivered the first intercontinental ballistic missile submarine, USS Robert E. Lee, and one year later, built the world's first Nuclear Aircraft Carrier, USS Enterprise, plus the Nuclear Attack Submarine, USS Shark.[4]

B. COMPOSITION

The Shipyard is divided into four profit centers: commercial ship repair, commercial ship construction, industrial work, and Naval Construction and Repair. The Yard has always done commercial repair work, ranging in scope from less than one week trip work to extensive overhauls lasting several months. Repair work is highly profitable and is limited only by space and labor. The Yard turns away $50 million worth of work, equal to that which it performs each year.[5]

Newport News had always built commercial ships, but in 1971, it had been two years since the Shipyard finished the last of five cargo vessels for the American Mail Lines.

Now, the Shipyard has completed a 150 acre, land-fill expansion of its commercial facility on the James River. Its pride is a new 1600 feet long by 250 feet wide graving dock, with a mammoth 900 ton gantry crane which is 540 feet between rail centers.[6]

Newport News is now constructing six ships (worth $200 million) in its commercial yard. Three of these are LNG ships, (two of which have now been launched) for the company's Algeria to East Coast run. The three remaining are ULCCs, (ultra large cargo carriers) of 390,000 DWT. The ULCCs, two of which are for Shell Oil Company, will be the largest ships ever built in North America. The building of these ships at Newport News and the required building of the large new facility may have been the result of the Navy's decision to refrain from assigning the steel priority to Todd Shipyards when Todd was attempting to build these ships.[7] Had Todd been able to obtain the steel, the new facility might have been located on the southern Gulf Coast.

In the past, the Newport News Industrial Corporation has marketed the industrial capability of the yard machine shops and foundry, which amounts to 7% of sales; but, more recently, it is capitalizing on the yard's twenty five years of nuclear experience by involvement in the construction of three nuclear power stations. The largest, with the Cleveland Ohio Electric Company, amounts to over $100 million worth of work. The Newport News subsidiary, the Nuclear Service Corporation, has joined with General Electric and

Westinghouse in nuclear power station repair work, and looks to future expansion in this area.[9]

The source of this expertise (and the lion's share of the Yard's work) is the Navy ship construction, overhauls and repairs. Currently, Newport News is the only shipyard capable of building and servicing all Navy ships. This is, of course, because Newport is the only shipyard building nuclear surface vessels, particularly, nuclear aircraft carriers.

Current Projects

Newport News is currently building the aircraft carrier CVN70 Carl Vinson (named for a Congressional friend of Naval construction), two Virginia class Cruiser CGNs, 40 and 41, and four SSN688 class nuclear attack submarines. The yard has an additional eleven SSN688 class ships on a contract which extends into FY 1984. By the end of 1977, Newport News had, in one year, delivered to the Navy: the submarine Baton Rouge in June, the cruiser Texas in July, the carrier Eisenhower in September, and the submarine Memphis in December. This is a peacetime record for nuclear tonnage.

In addition to the nuclear construction, Newport News overhauled, repaired and refueled three nuclear submarines in 1977. At present, there are only six commercial and Navy yards capable of refueling nuclear ships. Refueling, which may take up to two years to complete, is an extensive process only surpassed in complexity and magnitude of effort by new ship construction. Refuelings are now done on an allocation basis. Recent labor shortages and Trident contracts at General Dynamics indicate that an increased capacity is

required. Newport News, on its own and at considerable capital investment and risk, is expanding its refueling capacity. In January 1978, the yard started construction of a second large graving dock to be used solely for nuclear submarine overhaul and refueling.

APPENDIX C. NOTE ON NAVY SHIP PROCUREMENT

A. COMPOSITION OF FLEET

The Navy has seen the number of ships in the fleet decline markedly since 1968, when there were 976 ships, to 476 ships in 1976. In 1976, the active Navy fleet consisted of 13 aircraft carriers, 41 SSBN's, 64 SSN's, 159 surface combatants, and 199 amphibious and support ships.

The decline in number of ships is often explained as being the result of an increase in the sophistication, capability, and cost per unit. The reduced numbers are also explained in the economic reality of the Vietnam War and a "guns and butter" economic policy which left little for ship construction. The actual number of ships required to meet strategic international objectives, as well as domestic objectives, is itself subject to national debate. Current Congressional and Executive branches appear to have agreed on a total figure near 460 ships, consisting of 12 to 14 aircraft carriers and a mix of nuclear submarines, surface combatants, amphibious assault ships, and support ships.

Along with the restricted funding and low authorized numbers, the Navy and the construction contractors have not produced to the authorized levels, although they have surpassed the cost goals. It is not difficult to observe that, given the present production of 13 ships a year and an average life for these ships of 25 years, the resultant number of ships in the Navy will be some 325 and not the proposed number of 460.

The concept of military needs can and does change over the long program schedules and this will determine and possibly alter the number of ships of a given class which are procured. Another problem is the slippage in delivery schedules which can be two years or more. Prolonged schedules have two prominent effects: first, the cost of ships increases markedly; and, second, the extended schedule results in the inability to meet number goals.

The cost will increase when there is schedule slippage, primarily because of the absorption of the tremendous fixed costs and overhead in the shipyards, and these costs are amplified by escalation in the shipbuilding industry. In these shipyards, labor and material costs have increased at rates almost double those of any non-construction industry. In order to attempt to prevent delivery of obsolete weapons systems, changes are required to update a slowly developing system. This also contributes to cost growth.

The delivery schedule is a major factor on cost and numbers of ships constructed. Doubling the schedule will cut in half the number of ships delivered each year. In the early 1960's, the United States was producing 19 nuclear vessels a year from five commercial shipyards and two Navy shipyards. Today, there are only two shipyards, both commercial, producing nuclear ships: Newport News Shipbuilding and Drydock Company and the Electric Boat Division of General Dynamics. A recent estimate of their total combined output is eight vessels per year.

B. SHIP PROCUREMENT POLICIES AND PRACTICES

1. Evolution of Navy Organization

The procurement of ships by the Navy is as old as the country. The Navy's present organization, as shown in Exhibit 2, came about from the evolution of the Departments of the Army and Navy to the Department of Defense, and includes within itself the birth in 1966 of the Naval Ships System Command from the old Bureau of Ships and again, in 1974, when the Naval Ordnance System Command was combined with the Naval Ships System Command to form the Naval Sea Systems Command. At the present time, there is a distinct separation between those who operate the ships (represented by the Operational Navy) and the Naval Material Command (who are the procurers).

2. Acquisition Policies

Prior to 1964, the Navy practiced a policy of allocating ships to various shipyards on the basis of shipyard's ability to perform the work and on the basis of their backlog. Most of the design of these ships was done within what was then the Bureau of Ships. There was, to a degree, competition for Navy shipbuilding contracts.

During the period of 1968 to 1971, the Navy, under instruction from Mr. McNamara (who was Secretary of Defense) practiced total package procurement. Under this policy, the Navy would present requirements to the contractors and have the shipbuilders develop the ship concepts, designs, and then the actual construction, with only advisement from the Naval Ship Engineering Center. This was a highly competitive

process. This process provided another layer in addition to those of the Material Command and only hampered (by contracts) any real dialog with the operational force.

After 1971, the procurement process became totally competitive, with the conceptual design and contract design being done within the Naval Ship Engineering Center. Dr. Leopold, the present director of Naval Ship Design within the Naval Ship Engineering Center, has criticized the inconsistency of the Navy organization and policy in regards to the wavering policy of conceptual design and total package procurement. He suggested inhouse design of ships to provide clarity in requirements.

In 1975, when Congress passed the appropriations bill, they included a section (Title VIII) which required that all new major combatant ships for the strike force be nuclear powered. Exhibit C-1 gives the major points of Title VIII.

Another policy, which was adopted in 1976, was the Five-Year Defense Program. This program has a dual purpose. The first purpose is to obtain funds for shipbuilding for an extended period of time and the second is to provide to industry a basis for long range planning.

EXHIBIT C-1

TITLE VIII OF THE DEFENSE DEPARTMENT
APPROPRIATION AUTHORIZATION ACT, 1975

Section 801. Makes it the policy of the United States to modernize the Navy by building major combatant vessels for the strike forces with nuclear power.

Section 802. Defines major combatant vessels for the strike forces as including combatant submarines; combatant vessels for aircraft carrier task groups which include aircraft carriers and the cruisers and destroyers which accompany them; and combatant vessels of these types designed for independent missions where essentially unlimited high speed endurance will be of significant military value.

Section 803. Requires the Secretary of Defense to submit to Congress a written report each year which presents the Department of Defense Five-Year Defense Program for construction of nuclear powered warships.

Section 804. Defines the conditions under which it is legal for the Department to request authorization of appropriations from Congress for major combat vessels for the strike forces which are not nuclear powered. The President must include in his request and a nuclear ship alternative to his proposal and Congress may decide whether or not the choice is to be a nuclear vessel.

APPENDIX D. NOTE ON CLAIMS PROCEDURES, HISTORY AND CONTRIBUTING FACTORS

A. PURPOSE

The purpose of this chapter will be to outline the procedure for claims processing in the Navy. In addition, an abbreviated history of claims will be presented. The final section will give background into some of the causes of claims and effects of claims.

B. REVIEW OF CLAIMS PROCESS

The present system for processing claims is made up of three levels: the contracting officer level, the administrative level (or agency head level), and the judicial level. Throughout the dispute process, work must continue on the contract, and at any time during the process, both parties can decide to settle the issue by negotiation and agreement.

The contracting officer derives his power in this process from the disputes clause written into government contracts. This is normally the standard ASPR disputes clause for supply and construction contracts which provides that any dispute concerning a question of fact (and which is not disposed of by agreement) shall be disposed of by a unilateral decision by the contracting officer. The contractor may then appeal his decision to the Armed Services Board of Contract Appeals (ASBCA).

The ASBCA is a single board of attorneys within the Department of Defense that represents the heads of the Military Departments in deciding appeals from a contracting officer's

decision. The dispute must arise under the contract and the finality of the decision is limited to questions of fact. Only the courts may ultimately decide questions of law. Heading the board is a chairman and two vice-chairmen, each of whom is appointed for a two-year term by the Assistant Secretary of Defense (I&L) and by the departmental Assistant Secretaries responsible for procurement. One important aspect of the ASBCA is that a decision rendered by the board which is deemed adverse by the Government cannot be appealed, while the contractor can appeal any decision of the board.

If the dispute involves a breach of contract for which there is no administrative relief, the Court of Claims or a U.S. District Court (for claims of $10,000 or less) has jurisdiction over the appeal, and the contractor must go directly to the courts. While the contractor has only 30 days to file a dispute, the statute of limitations for a breach of contract claim allows six years to institute a suit in court. The contractor can obtain a court decision by appealing the ASBCA decision.

While the disputes clause provides for settlement of disagreements within the contract as written, Public Law 85-804 provides for relief outside the contract. Under this law relief can be given when it facilitates national defense. Among other things, the following types of extraordinary contract amendments outride the terms of existing contracts, if this action will aid the national defense: (1) amendments without consideration, (2) amendments correcting mutual mis-

takes and ambiguities, and (3) amendments and contracts formalizing informal commitments.

An amendment without consideration is authorized when a contractor suffers a loss on a defense contract because of Government action. This could be the case, even where the Government is not liable as a matter of law, but fairness dictates that some adjustments must be made to a contract. The last two amendments do, as was stated, clarify mutual mistakes and formalize informal commitments.

Under normal conditions the contractor requests relief under Public Law 85-804 and does so only after all administrative methods have been pursued.

C. ADMINISTRATION OF THE PROCESS

There is a great deal of administrative effort required to adjudicate a claim. Prior to the contracting officer's decision, a team composed of legal and technical advisors is created to study the claim and make recommendations. After the contracting officer makes his decision as to settlement, the procuring agency and/or personnel in Headquarters, Naval Material Command (NAVMAT) conduct a detailed review of that decision.

The composition of the claims team has changed because of increasing claims, increasing visibility of claims, and by changes in the head of the NAVMAT organization. In October 1969, the Chief of Naval Material (CNM) established the Contract Claims Control and Surveillance Group (CCCSG) under the chairmanship of the Director of Navy Contract Clearance,

Mr. Gordon Rule. The object of a CCCSG was to determine if the proposed settlement figure had complete, substantive merit and was adequately supported by documented evidence. When Admiral Isaac Kidd became CNM in the fall of 1971, he abolished the CCCSG, and in its place, established a NMC Claims Board and a General Board for Claims Review. The intention was to have claims settled at the lowest possible level in the contracting framework and to raise the value of claims that must be reviewed by the General Board to $10 million. In 1976, because of increasing volume of claims, increasing dollar amounts, and importance placed on equitable settlement, Admiral Manganaro was appointed to head a "Navy Claims Settlement Board," thus returning claims settlement to a very high level and eliminating lower teams.

The contractor, as noted earlier, can appeal the decision of the Navy claims board by submitting to ASBCA a Notice of Appeal identifying the contract, the contracting officer, and the decision from which relief is requested. This document is submitted to the contracting officer, who must send it on to the ASBCA within ten days. Within thirty days of ASBCA notice that the case has been docketed, the contractor must submit the complaint which outlines the contractor's position and gives the type and amount of relief requested. The government, after receipt of notice, must submit the following in accordance with ASPR Appendix A, part 2 (Rule 4):

1. The findings of fact and the decision from which the appeal is taken, and the letter or letters or other documents

of the claim in response to which the decision was issued.

2. The contract, and pertinent plans, specifications, amendments, and change orders.

3. Correspondence between the parties and other data pertinent to the appeal.

4. Transcripts of any testimony taken during the course of the proceedings.

5. Such additional information as may be considered pertinent.

The Government must file an answer to the complaint which gives a defense of each item in the complaint within thirty days of when the complaint was filed. Amendments to the contractor's complaint and the Government's defense may be filed at any time, subject to the ASBCA's discretion. A major complaint with this portion of the process is that it is too time consuming, costly, and complicated. In addition, if there is any delay by the Government in preparing its position, this may become an issue in the dispute.

To prevent any further litigation of the same dispute after the ASBCA decision, the contracting officer must submit a supplemental agreement stipulating final adjudication of issue.

D. CLAIMS HISTORY

Claims against the Government for the construction of warships are not new. Table D-1 gives a brief history of the claims, showing the number of claims, dollar value of claims, and number resolved for the period 1967 to 1973.[1]

TABLE D-1. STATISTICAL SUMMARY OF CLAIMS

Year	Number of New Claims	Amount	Number of Claims Resolved	Number of Claims Unresolved	Amount for Claims Unresolved	Claims on Appeal to ASBCA Number	Claims on Appeal to ASBCA Amount
1967	4	$ 39.1 M	0	4	$ 39.1 M	10	$ 27 M
1968	17	121.0 M	0	21	215.1 M	23	22 M
1969	25	336.9 M	4	42	489.2 M	15	29 M
1970	16	116.6 M	13	45	551.5 M	18	54 M
1971	31	405.1 M	6	70	904.1 M	25	89 M
1972	5	280.0 M	36	39	680.7 M	43	241 M
1973	3	29.4 M	12	30	552.8 M	26	724 M

In 1967, the value of the claims submitted to the Government was $39 million, jumped to $900 million in 1971, fell off slightly to $500 in 1973, and at the end of 1976, the value of the claims outstanding against the Government was $2.46 billion on contracts valued at $4.6 billion.

The following example gives a breakdown of several claims that have been settled with Newport News Shipbuilding and Drydock Company:

1. Settlement of the LKA 113-116 claim.
   a. The claim was based on deficient GFI and Government actions constituting constructive changes, resulting from late GFE and excessive inspections.
   b. The amount of the claim was in excess of $29 million and was settled for $15.5 million.[2]
2. Settlement of DLGN 36-37 claim.
   a. The claim was based on delay and disruption with the following breakdown:
      (1) $9,106,226 for hardware on 24 change orders which contractor has attributed delay to.
      (2) $24,634,581 for delay attributed to the 24 change orders.
      (3) $3,282,700 for disruption attributed to the 24 change orders.
      (4) $285,000 for constructive changes for correction of accessibility items.
   b. Claim was originally submitted for $35 million but was adjusted to $151 million and settled for $44.3 million.

3. At the end of 1976, Newport News Shipbuilding and Drydock Company had six claims pending against the Government totaling $749.6 million and involving 13 ships. The following is a breakdown of each claim:[3]

a.	CVAN 68, 69	$221.3 million
b.	SSN 686, 687	$ 90.4 million
c.	SSN 688	$ 78.5 million
d.	SSN 688 class	$191.6 million
e.	CGN 38, 39, 40	$159.8 million
f.	SSBN 624	$ 7.8 million

E. ISSUES COMPRISING CLAIMS

There are many issues which can be the basis for a claim. In the remainder of this section, some of these issues will be defined so as to provide a better understanding.

1. Delay and Disruption:

   a. Delay claims represent costs incurred as a result of slippage in delivery of the ship. They include the increased cost of doing originally planned work in a later time period and additional "housekeeping" costs that occur when a ship is delayed. The contractor must show that delay is the responsibility of the Government.

   b. Disruption represents costs incurred when normal planned work must be rescheduled or redone due to unplanned or changed conditions. Disruption is probably the hardest area to definitize and on which to place a dollar value.

c. Contractors have recently cited another area which is very similar to disruption and is called the "ripple effect". This "ripple effect" is the adverse effect on other shipyard work as a result of delay or disruption on Navy shipbuilding. Here again, the determination of an accurate dollar value is most difficult and, until recently, the Navy has not recognized the validity of such a claim.

d. In 1972, the delay and disruption portion of the shipbuilder's claim constituted 47 or 48% of a claim, but today they constitute 88 to 90% of a claim.

2. Escalation

Due to the fact that shipbuilding contracts exist over an extended period of time, (from 5 to 10 years), a clause has been included in the contracts to provide relief from cost increases for material and labor. Prior to 1975, the period covered by the escalation clause was the delivery date specified by the contract. The amount of relief achieved was tied to the Bureau of Labor statistics. Beginning in 1975, a new escalation clause was developed and it stipulated that:

a. Escalation is paid on the basis of actual expenditure phasing.

b. Escalation is paid on the basis of allowable costs incurred not to exceed ceiling price.

c. Escalation continues to actual delivery date.[4]

This new clause was not made retroactive. Even though it would be desirable to have a uniform escalation clause for all contracts, the policy of custom tailoring the escalation clause to each contract is used. This is best demonstrated by Table D-2, where the escalation for three different contracts is shown.

3. Cash Flow

Even though cash flow is not a direct claim issue, it is an indirect cause of claims. When an adverse cash flow exists at a shipyard due to unadjudicated changes, the only recourse left to the contractor to obtain relief is to submit a claim. The basis for payment to the contractor for shipbuilding contracts is broken down to two parts. Until 50% of the entire contract (not necessarily each hull) is completed, the Government will pay 90% of physical progress as a percent of total provided, the total sum of such payments may not exceed 105% of contract cost. After passing the 50% completion point, the Government will pay 95% of physical progress up to 105% of contract cost. Once the contractor exceeds target cost, cash provided begins to lag cash spent. At Newport News Shipbuilding and Drydock Company, four of six fixed-price incentive Navy construction contracts are either over-running ceiling or are forecasted to over-run ceiling. An example of cash deficits are those experienced in 1974 when $30-70 million in deficit

TABLE D-2. COMPARISON OF DLGN, TRIDENT AND SSN 688-III ESCALATION CHARTS

		DLGN	TRIDENT	SSN-688-III
1.	Duration of Escalation	Initial Contract Delivery Date	Final (Actual) Delivery Date	Final (Actual) Delivery Date
2.	Multiplier	"Projected Final Cost" which cannot exceed ceiling price per Article 5A)	Monthly Base Cost	Monthly Incurred Costs
3.	BLS indices (whether modified)	Unmodified	Modified (for material)	Unmodified
4.	Labor and Material			
	a. %	54.6% labor 53.2% material	63% labor 30% material	None
	b. Tables	Yes	Yes but redeterminable to actual costs incurred	No
5.	Base Month	June 1970	November 1970	June 1974
6.	Payment Frequency	Quarterly	Monthly	Monthly
7.	Limitation of Payments	Payments deferred if in excess of total incurred costs (first 50%) or total incurred costs plus 5% (last 50%)	Payments deferred if in excess of incurred costs	1. If cumulative base costs exceed ceiling price, escalation ceases 2. Escalation "freeze" (BLS becomes fixed at month of scheduled delivery extendable for Government resp. and excusable delay)

Ref: Memorandum for General Counsel by B. P. Angrist and D. W. James Jr., 14 Feb 75.

was reported by Litton, Electric Boat Division of General Dynamics, and Newport News Shipbuilding and Drydock Company. Table D-3 shows the amount of money withheld in 1974 to these contractors.

F. PROBLEMS OF CLAIMS PROCESSING

Contractors see three major problem areas with the claims processing procedure: (1) the documentation required by the Navy in support of claims is excessive; (2) the claims settlement process is lengthy and cumbersome; and (3) the entire claims process employed by the Navy is costly and unfair.[5]

The Navy agrees that the documentation required is excessive, but is necessary to provide adequate safeguards. To achieve this end, the Navy Procurement Directives require that a contractor's claim show: (1) legal basis for entitlement; (2) facts meeting the elements of proof required to support the basis for entitlement; and (3) adequate factual support and documentation for the amount claimed in as much detail as the facts permit. As stated in a recent review by the GAO, the contractor has the legal burden of proving his claim, and that burden must be carried by providing sufficient support to establish the facts he alleges. Many times, the Navy is required to request additional information from contractors after initial submission of the claim.

The claims process is lengthy and cumbersome and part of this is due to the Government bureaucracy through which a claim must go. But the shipbuilders are also responsible for some of the delay. To illustrate, some shipbuilders

TABLE D-3

Shipyard	Period Ending	Amount Withheld
Electric Boat	7/31/74	$26,371,000
Newport News	8/23/74	$52,679,000
Litton	7/31/74	$128,291,000

submit documentation in support of claims that contain more trivia than substance; they revise their claims several times during the course of analysis and settlement; and they submit claims based on unrecognized legal theories.

Resolving a claim requires a large investment of manpower by both the contractor and the Government. One reason that shipbuilders appeal to the ASBCA and the courts is that they often receive substantially more by this means than they do from a unilateral decision by a Navy contracting officer. An example was a case with Litton where they were awarded $3.8 million by the contracting officer and $17 million by the ASBCA.

G. REASONS FOR CLAIMS

Some say that claims result from the fact that contractors lose money on shipbuilding contracts. As stated by RADM Gooding in 1974, there were many events occurring simultaneously which resulted in contractor losses. One of these events was the need to replace a fleet that was becoming obsolete. At this time, industry infrastructure had deteriorated and was not prepared for the onslaught. The decision was made to rebuild in the late 1950's, and through the early Kennedy years, prices remained fairly stable, but expansion meant rising costs and reduced availability of manpower.

Another event which changed the face of Navy shipbuilding occurred in 1964. Prior to 1964, contracts for shipbuilding and ship classes were allocated to industry depending upon available facilities, and through this procedure,

major shipbuilders were fairly well assured of their share of available business at prices which considered individual circumstances. Starting in 1964, the Navy began using formal advertising for large quantities of ships. Because of this procedure, the competition was intense, occurring when costs and labor were fairly stable. It was possible to make a profit, but expansion and modernization were needed. With the occurrence of the Southeast Asia conflict, there was inflation and stiff competition for the available labor pool.

As of April 1976, all claims and appeals outstanding were submitted under contracts which were awarded in the period 1967 to early 1971.[6] This was when the previously described factors were most prominent.

Admiral Rickover has asserted for many years that the problems plaguing shipbuilding were not due solely to socio-economic conditions. The major reason for losses, according to Admiral Rickover, is poor shipyard management. In his opinion, private shipyards are not run by technical managers or experienced shipbuilders, but rather by legal, financial, and contract experts. He attributes this factor in part to the fact that the shipyards are owned by large conglomerates, and they are interested in making money, not building quality ships. The major causes of claims in Admiral Rickover's estimation are:

1. Most of the major shipbuilding contracts, especially those for nuclear powered ships, are awarded sole-source or

with only limited competition. Additionally, the Navy is using incentive type contracts which places the greatest risk of cost overruns on the Government.

2. There are no incentives given to the contractor to control costs or efficiency. Because of this, the Department of Defense, in reality, rewards higher costs with higher profits, and punishes efficiency with lower profits.

3. As long as shipbuilders know that the Government will bail them out through changes and claims, it will be impossible to achieve effective cost control, improved efficiency, or lower costs.

In addition, Admiral Rickover stated:

> "The Government and members of the shipbuilding industry have become mutually hostile groups in that one desires a satisfactory product at a reasonable price while the other appears to desire the greatest price the traffic will bear. These antipathies will continue to the detriment of the shipbuilders and the Government unless there is developed a self-discipline manner of dealing with one another. What we need between these two hostile groups is the greatest courtesy and consideration. We need a moderation and mutual consideration in their behavior that is not evident today."[7]

H. CLAIMS RESOLUTION

Many of the issues which are the foundation of claims are present in this case. Some of the other issues that are present in claims, but were not covered in this case, are late and defective GFE, late or inaccurate GFI, delay and disruption, and change orders. Delay and disruption are outgrowths of changes and late or defective GFE and GFI. A major percentage of claims are hard to definitize in dollar amounts.

Contractors claim that the documentation required in submitting a claim is excessive and that the settlement process is lengthy and cumbersome.

On the issue of excessive documentation, the Navy contends that it is necessary to ensure that the best interests of the Navy are protected and that the monies awarded are justified by fact. As stated in a report by GAO, the contractor has the legal burden of proving his claim and must provide sufficient data to establish the facts.

On the issue of the required documentation to resolve claims, the Navy points out there are contractor caused delays due to incomplete documentation, revisions submitted during review, and claims that are based on unrecognized legal theories. The Navy recognizes that the process is too lengthy and has made recommendations to streamline the process. The most significant improvement was the establishment of the Claims Review Board headed by Admiral Manganaro. The Claims Review Board is permanent, whereas before, a new board was established whenever a claim was received, thus causing a delay. The Navy has stated its desire to pay what it owes and will work to that end. Even though some changes have been made to expedite claim resolution, more effort has been directed toward improvements in contracting so as to reduce claim submission.

Another issue brought out in this case was the use of P.L. 85-804. Deputy Secretary Clements proposed using extraordinary contractual relief to eliminate all existing claims

and to improve relations with contractors. Even though it was finally decided not to use P.L. 85-804, the effect of this statute on future contracting was questioned by Admiral Rickover. He cited the following problems:

1. How to handle other defense contractors and subcontractors when they request extracontractual relief.
2. How to get Congressional approval for extracontractual payments to large conglomerates who are reporting large profits.
3. How to negotiate payments with contractors so that it is equitable for all and still satisfies everyone.

He further stated that P.L. 85-804 will not eliminate the basic problem and it may become harder to conduct business in the future because: (1) shipbuilders may conclude that their present approach of accumulating a large backlog of claims is highly effective. The shipyard's manpower availability is still acute and there may be a financial incentive to divert manpower from Navy to expanding commercial work, if the Navy pays for all delays on Navy work; (2) the Navy will remain vulnerable because of the limited number of shipyards and their assertion that they will not perform unless claims are settled to their satisfaction; and (3) the Navy will still have to spend considerable time in negotiating and administering contracts, trying to pre-price changes, and contesting unwarranted claims, knowing that the possibility exists for relief if there are overruns.

Admiral Rickover has also been a proponent of nationalizing the shipyards, as noted earlier, because of the apparent

unwillingness on the part of the Navy to enforce fixed price contracts. In his opinion, a claim changes a fixed price contract into a cost type contract.

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